CERTAIN ASPECTS OF LIFE INSURANCE COMPANY TAXATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

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CERTAIN ASPECTS OF LIFE INSURANCE COMPANY TAXATION

TUESDAY, SEPTEMBER 27, 1988

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, DC.

The subcommittee met, pursuant to notice at 10:15 a.m., B-318, Rayburn House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
FRIDAY, SEPTEMBER 9, 1988

PRESS RELEASE #11
SUBCOMMITTEE ON SELECT
REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D. N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A PUBLIC HEARING ON LIFE INSURANCE COMPANY TAXATION

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing on certain aspects of life insurance company taxation on Tuesday, September 27, 1988, beginning at 10:00 a.m. in room B-318 Rayburn House Office Building.

The Subcommittee will review the provisions governing the taxation of the life insurance industry which were substantially revised in the Deficit Reduction Act of 1984 ("1984 Act"). The hearing will focus on preliminary data showing the amount of taxes paid by the life insurance industry, and the relative tax burden of mutual life insurance companies and stock life insurance companies since the enactment of the 1984 Act. In this regard, the Subcommittee will consider the Interim Report to the Congress on Life Insurance Company Taxation prepared by the Department of Treasury, dated June, 1988, which was mandated by Congress in the 1984 Act.

The Subcommittee encourages testimony based upon the Interim Report and any further testimony which will assist the Subcommittee in reviewing the amount of taxes paid by the insurance industry and the relative tax burdens of segments of the industry.

It is anticipated that the Subcommittee will utilize this hearing to review the 1984 Act provisions and available preliminary data regarding the effects of that Act. However, the Subcommittee will make no legislative recommendations regarding this issue during this Congress.

The Treasury Department is expected to be the first witness. Public testimony is invited.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler or Diane Kirkland [(202) 225-1721] no later than Tuesday, September 20, 1988, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearings. See formatting requirements below. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

(MORE)

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements to the Subcommittee office, room 1111 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies of their statements by the close of business, Tuesday, October 11, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1111 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

* * * * * * * * *

Chairman **Rangel**. The Subcommittee on Select Revenue Measures will come to order. Today's hearing is on certain aspects of life insurance company taxation.

Five years ago, this subcommittee undertook a comprehensive review of the taxation of life insurance companies. This study resulted in the provisions of the Deficit Reduction Act of 1984 (the "1984 act") which substantially modified the taxation of life insurance companies.

As part of that legislation, Congress mandated that the Treasury Department study the impact of the provisions and provide Congress with interim reports on the revenues received under these life insurance provisions, comparing such revenues with the revenue anticipated as a result of the 1984 act changes. Treasury is further required to report on the effects of the 1984 act provisions on the balance of revenue between the different segments of the life insurance industry. In addition, the Treasury is required by provisions of the 1984 act to make a final report by January 1, 1989.

The sole purpose of today's hearing is to receive testimony from Treasury regarding the first interim report to Congress and to hear from others who have been studying the revenue impact of the 1984 legislation and who will assist the subcommittee in understanding those complex provisions.

This hearing will review data and information regarding the 1984 act. We will not legislate or make any recommendations to the full committee as a result of this but merely to get a better understanding as to the impact of what has already been done.

I also would like to point out that I have been advised by Mr. Vander Jagt that, because of the urgency of another legislative matter now in conference, some, if not all, of the minority will have to leave at some point and return.

At this point, I would like to yield to Mr. Vander Jagt.

Mr. **Vander Jagt**. Thank you very much, Mr. Chairman.

Mr. Chairman, because of your outstanding fairness and objectivity, we feel very comfortable on the minority side stepping outside for a few moments knowing that the hearings will be continued in your usual outstanding manner.

I notice your hearings have elicited a great deal of attention and interest.

Chairman **Rangel**. They thought it was the welfare hearing.

Mr. **Vander Jagt**. I do want to commend you for holding these hearings. As you said, it is an interim report from Treasury growing out of the changes that we made in the Tax Code in 1984. At that time, we made certain projections about revenue and about the mix of that revenue. Unfortunately, I think we missed our projections. I think it is important that we find out why and if there is anything that we ought to do about it.

Since these issues are so complex, I would like to request that after the testimony is received, the record can remain open for a little while, so we can have the opportunity to submit additional questions to the witnesses if we so desire.

Thank you, Mr. Chairman.

Chairman **Rangel**. With that we're done. Without objection.

Mrs. Kennelly indicated that she has been called to an Intelligence Committee meeting and that she will be joining us later, but certainly supports the review of the life insurance provisions of the 1984 Deficit Reduction Act, and her full statement will be entered into the record.

[The opening statement of Mrs. Kennelly follows:]

Statement of Representative Kennelly

Mr. Chairman, regrettably the Select Committee on Intelligence is having a meeting which I cannot miss, and which began a few moments ago. I will be back as soon as that meeting is over.

I would simply like to note that this is a hearing on an interim report and that we will be getting more current data over the next 6 months. I do believe it is useful to review where we are on the life insurance provisions of the 1984 Deficit Reduction Act. I will be reading the written testimony submitted by the witnesses and appreciate their work and the staff's work in preparing for this hearing.

Thank you.

Chairman Rangel. If there is no member seeking recognition at this point, then I would like to call Thomas Neubig, the Director of the Office of Tax Analysis from the Department of the Treasury.

Mr. Neubig, welcome to the committee. Your long service with the Treasury has not afforded you the opportunity to be with us. We understand this is your maiden appearance, and we want you to feel comfortable and proceed as you would like.

Your full statement will be in the record without objection.

STATEMENT OF THOMAS S. NEUBIG, DIRECTOR AND CHIEF ECONOMIST, OFFICE OF TAX ANALYSIS, U.S. DEPARTMENT OF THE TREASURY

Mr. Neubig. Thank you, Mr. Chairman, and members of the subcommittee.

I am pleased to have this opportunity to discuss the results of the Treasury report, the Interim Report to the Congress on Life Insurance Company Taxation, that we released in June 1988.

The Deficit Reduction Act of 1984 substantially altered the tax treatment of life insurance companies. During the consideration of the 1984 act, the Congress expressed concern about the amount of taxes paid by the life insurance industry, and also about the relative tax burden paid by the mutual (policyholder-owned) companies and the stock (shareholder-owned) companies.

I would like to emphasize at the outset that the Treasury Department is not here today to evaluate the success of the 1984 act in improperly taxing life insurance companies, or to suggest the appropriate tax burden of the life insurance industry or its mutual and stock segments.

The Treasury Department believes that it is more appropriate for tax legislation to attempt to measure accurately the economic income of corporations rather than to target for particular revenue from an industry or from segments of that industry.

We intend to continue our analysis of the life insurance company tax rules and also possible changes to those rules, and will present to you the final report on life insurance company taxation early next year. We are shooting for the January 1, 1989, target.

I am sure that you will be presented today with hundreds of numbers. Some will be from financial statements; some will be from IRS statistics; some will be from our special Treasury survey;

some will be on a consolidated basis; some will be on a separate life subgroup basis.

Without getting into the gory details of the numbers, I would like to explain why revenue estimates can differ from final tax collections and why they differed for the life insurance industry in 1984 and 1985.

The interim report used a special survey of over 300 life insurance companies to get the best possible measure of the life insurance industry's taxes. These data are an important improvement over information previously available from financial statements and from IRS statistics. Due to differences in the definition of the life insurance company and the life insurance industry, due to differences in the consolidation rules between life and nonlife affiliated companies, and also differences in what is actually included in the measure of taxes paid reported on tax returns of financial statements, we believe the Treasury survey results are the only reliable data on life insurance company taxes.

These survey data indicate that the recent changes to the life insurance company tax rules resulted in less additional revenue than we predicted at the time of the 1984 act. In particular, the tax payments of the life insurance industry and the relative share paid by the mutual and stock segments in 1984 and 1985 did not meet congressional expectations.

There are a number of reasons why revenue forecasts will not match the actual numbers. An accurate revenue forecast requires a number of predictions. It requires an accurate general economic forecast of GNP, interest rates, and inflation. It requires an accurate forecast, in this case, of the market share of the life insurance industry vis-a-vis other financial institutions. It also requires an accurate forecast of the market share of the mutuals and the stocks. It requires an accurate forecast of the industry's investment income, underwriting income, and policyholder dividends. It requires an accurate modeling of the Tax Code changes which were extremely complex. For instance, in the 1984 act, the changes in the life insurance company reserve rules affected the reserves for policies issued back in 1910 and 1920. The 1984 changes were not made prospectively.

Finally, an accurate forecast of the revenue requires an accurate modeling of the industry's behavior with respect to the tax law change. For your information, we do try to incorporate behavior changes in our estimates, but we may either over- or under-estimate the behavioral changes due to tax law changes.

It has been particularly difficult to forecast the revenue changes of the life insurance industry during the 1980's due to the complexity and the rapidly changing nature of both the industry and its tax rules. The use of modified co-insurance by the industry during 1979 to 1981 unexpectedly decreased insurance industry taxes and also resulted in a lot of double counting in the industry statistics.

The consolidation of life insurance companies with nonlife companies for tax purposes began in 1981 and, at the time of the 1984 act, we did not have any information from tax returns with respect to the effect of consolidation.

Also, at the time of the 1984 act, we had just undergone major changes to the life insurance company tax rules in the 1982 Tax

Act which instituted 2-year temporary provisions making a number of changes. Those temporary relief provisions for the life insurance industry coincided with a general economic downturn in 1982 and 1983. These changes made it difficult to predict the amount of revenue expected from the industry before the 1984 act changes were even made. And the comprehensiveness of the 1984 act which completely overhauled the industry's tax rules made estimation of the revenues from the industry even more difficult.

The Treasury Department and the Joint Committee on Taxation estimates of the revenues expected from the life insurance industry after the 1984 act were quite similar. Revenues were expected to grow from $3 billion in calendar year 1984 to roughly $3.8 billion in 1988. The industry paid less than expected in taxes. In 1984, the industry paid $2.4 billion based on the Treasury survey data, compared to the estimated $3 billion.

In 1985, the industry paid $2.9 billion compared to an estimated $3.2 billion. The mutual segment paid $1 billion in 1984 instead of the estimated $1.6 billion. And they paid $1.3 billion in 1985 instead of the estimated 1.7 billion.

The stock segment paid the same amount as we projected in 1984. They paid $1.4 billion, though I would note that that was due to offsetting errors. They had higher income and also higher net operating losses. So it was a happy coincidence that they paid the same amount as expected. In 1985 they paid slightly more than expected.

Estimates of the industry's revenues in 1984 and 1985 were affected by a number of factors. Both segments had large net operating losses which they generated in 1982 and 1983, and carried forward to reduce tax liability in 1984 and 1985. These net operating losses were not a result of the 1984 act but were the unexpected results of the 1982 Tax Act provisions. Due to normal lags in IRS corporate statistics, we were unaware of these large net operating losses at the time of the 1984 act.

We also underestimated the income of stock life insurance companies, and we overestimated the income of mutual life insurance companies. This may have been the result of the stock segment's market share increasing at the expense of the mutual segment's market share, which is something that happens all the time in our economy.

We also overestimated the amount of equity of the mutual companies due to the reliance on financial statement data that was the only available data at the time of the 1984 act. We may also have overestimated the equity of the mutual company by underestimating the possible tax minimizing behavior of the mutual segment. We did try to anticipate tax minimizing behavior but we may have underestimated it.

Finally, we also underestimated the stock company return on equity in 1981 to 1983 due to reliance on financial statement data.

Again, I would like to emphasize that estimating the revenue effects of the life insurance industry is extremely difficult due to the complex and rapidly changing nature of the industry and its tax rules. We would do a better job today due to the improved data, the improved modeling, and our improved understanding of the industry, its tax rules and its behavior. Even still, any estimates would remain subject to the uncertainty of future changes in the economy and the industry.

In conclusion, the fact that the 1984 life insurance tax changes did not raise as much taxes as Congress expected does not imply that the 1984 act changes were ineffective. In fact, the 1984 act changes did tax life insurance companies more like other corporations, which was one of its goals.

The Treasury Department believes that tax legislation should attempt to measure accurately the economic income of corporations rather than trying to hit specific revenue targets. And we intend to evaluate the tax rules affecting life insurance companies, particularly the rationale and operation of section 809, which limits the mutual segments' policyholder dividends, and will be completing the final report to Congress early next year.

This concludes my remarks. I believe we have made available copies of the report to the Members of Congress and to their staff. And I would be happy to answer any questions.

[The statement of Mr. Neubig follows:]

For Release Upon Delivery
Expected at 10:00 a.m. EST
September 27, 1988

STATEMENT OF
THOMAS S. NEUBIG
DIRECTOR AND CHIEF ECONOMIST
OFFICE OF TAX ANALYSIS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to discuss the results of the Treasury Department's Interim Report to the Congress on Life Insurance Company Taxation. The Deficit Reduction Act of 1984 (the "1984 Act") substantially altered the tax treatment of life insurance companies and their products. During the consideration of the life insurance company provisions, the Congress expressed concern about two issues: (1) the amount of taxes paid by companies in the life insurance industry; and (2) the relative tax burden of mutual (policyholder-owned) and stock (shareholder-owned) life insurance companies. The interim report responds to the congressional directive contained in the 1984 Act that the Treasury Department conduct a study of those issues.

My testimony today will first discuss the rules governing the taxation of life insurance companies before and after the 1984 Act. Second, I will discuss the results of the Treasury Department's interim report on the amount of taxes paid by life insurance companies since the 1984 Act and the relative tax burdens of the mutual and stock segments of the life insurance industry. The analysis of the revenue effect of the 1984 Act is based upon data reported to the Treasury Department in a special survey of life insurance companies. These data are an important improvement over information previously available from financial statements and IRS statistics.

Although the interim report contains information that may assist the Congress in its review of these issues, I would like to emphasize at the outset that the Treasury Department is not here today either to evaluate the success of the 1984 Act in properly taxing life insurance companies or to suggest the appropriate tax burden of the life insurance industry or the mutual or stock segments. We intend to continue our analysis of life insurance company tax rules and possible changes, and to present the final report on life insurance company taxation to the Congress early next year.

I. Summary of Prior and Current Law Taxation of Life Insurance Companies

Since 1921, life insurance companies have been subject to tax under three different sets of rules. Between 1921 and 1958, life insurance companies were taxed only on "free" investment income.

Free investment income was the amount of investment income that was not needed to fund obligations to policyholders. This amount was calculated under formulas that changed over the years. Income and losses from underwriting operations (e.g., premium income and benefits paid to policyholders) were ignored as were gains and losses from the sale of investment assets.

Between 1958 and 1984, life insurance companies were taxed under a complex "three-phase" system enacted by the Life *Insurance Company* Tax Act of 1959 (the "1959 Act"). The three phases referred to the three different tax bases that could be applicable to a life insurance company. The first tax base was the company's free ("taxable") investment income. The second tax base was the company's gain from operations. The gain from operations tax base included premium income and investment income not needed to fund obligations to policyholders. In calculating gain from operations, deductions were allowed for additions to reserves for future obligations. The amount of the reserve deductions was generally equal to the amount of the additions to the reserves required by state regulators. In addition, limited deductions were allowed for policyholder dividends and certain "special deductions."

Under the 1959 Act, a life insurance company was taxed on the lesser of its taxable investment income or its gain from operations. In calculating its gain from operations, however, the amount of deductions for policyholder dividends and special deductions was limited to $250,000, plus the amount by which the gain from operations (before these deductions) exceeded taxable investment income. Thus, these deductions could not reduce a company's taxable income to more than $250,000 below its taxable investment income. If a company's gain from operations exceeded its taxable investment income, the company was taxed on 50 percent of such excess. The untaxed gain from operations (along with the special deductions) was added to a deferred tax account and, subject to certain limitations, was taxed only when distributed to shareholders. When triggered, this deferred tax account was the third tax base under the 1959 Act.

The existence of multiple tax bases under the 1959 Act produced differing tax treatment of different types of income. For example, a company that had reached the limit on the deduction of policyholder dividends and special deductions would be taxed on the receipt of additional investment income, but not on the receipt of additional underwriting income. Life insurance companies were able to manipulate the character of their income by entering into so-called "modified coinsurance" transactions.

In a modified coinsurance transaction, the ceding company retained ownership of the assets and the reserve liabilities connected with the risks reinsured. Former section 820 of the Code, however, permitted the parties to treat the transaction as if the assets and reserves had been transferred to the reinsurer. As part of a modified coinsurance transaction, the reinsurer would pay "experience refunds" to the ceding company. The experience refunds reflected investment income earned by the ceding company (which under section 820 was deemed to be earned by the reinsurer) but were characterized as underwriting income to the ceding company. Thus, a modified coinsurance transaction had the effect of converting taxable investment income of the ceding company into more favorably taxed (or untaxed) underwriting income.

The special treatment of modified coinsurance transactions under former section 820 of the Code was repealed by the 1982 Act. At the same time, however, the limitation on the deductibility of policyholder dividends was revised for a temporary two-year period. In general, under the revised limitation, a partial deduction (85 percent for stock companies and 77.5 percent for mutual companies) was allowed for all policyholder dividends. Several other favorable tax provisions were enacted for a temporary two-year period.

The rules for taxing life insurance companies were substantially revised in 1984 in response to concerns that the 1959 Act rules were unduly complex, did not work well in a high interest rate environment, and taxed life insurance companies differently from other corporations. Under the 1984 Act, life insurance companies are taxed on a single income tax base corresponding generally to the tax base applicable to other corporations. Many of the special deductions and accounting rules that had applied under the 1959 Act were repealed. Even with these changes, however, the tax base of life insurance companies differs from that of other corporations in three significant respects.

First, 1984 Act allowed life insurance companies a "special life insurance company deduction" and a "small life insurance company deduction." The "special" deduction, which was repealed by the Tax Reform Act of 1986, was equal to 20 percent of the company's taxable income from insurance businesses, and had the effect of reducing the maximum marginal rate of tax on this income from 46 percent to 36.8 percent. The "small company" deduction, which applies to companies with assets of less than $500 million, is equal to 60 percent of the first $3 million of the company's taxable income from insurance businesses, and is phased out at income levels of between $3 million and $15 million.

Second, as under the 1959 Act, life insurance companies are allowed to deduct additions to life insurance reserves and similar items. In calculating the maximum amount of the reserves, the 1984 Act required that the reserves be calculated using Federally prescribed rules. In general, the Federally prescribed reserve rules specify a tax reserve method and require use of the highest interest rate and most recent mortality or morbidity table permitted to be used by insurance regulators in a majority of states. For taxable years beginning after 1987, the interest rate that must be used in calculating reserves is the greater of the prevailing state rate or a five-year average of the Federal mid-term rate.

Third, to address the perceived tax advantage of the mutual form of organization, the 1984 Act imposed a limitation on the deduction by mutual life insurance companies of policyholder dividends. Under section 809 of the Code, the deduction of policyholder dividends by a mutual company is reduced by the company's "differential earnings amount." The differential earnings amount is equal to the product of the mutual company's average equity base and the "differential earnings rate." The differential earnings rate, in turn, is equal to the excess of the "imputed earnings rate" (90.55 percent of a three-year average of the earnings rates of the 50 largest stock life insurance company groups) over the average earnings rate of all mutual life insurance companies for the second calendar year preceding the taxable year. The differential earnings amount for a taxable year is "recomputed" in the subsequent taxable year. The recomputed amount reflects the average mutual earnings rate for the calendar year in which the taxable year begins (rather than the second preceding calendar year). The difference between the differential earnings amount and the recomputed differential earnings amount (the so-called "true-up") is included in income, or deducted, in the subsequent year.

For example, the differential earnings amount of mutual companies for 1985 was calculated using the 1983 average mutual earnings rate of 10.166 percent. The recomputed differential amount for 1985 was calculated using the 1985 average mutual earnings rate of 13.135 percent. The difference between the differential earnings amount for 1985 and the recomputed differential earnings amount for 1985 (i.e., 2.969 percent of each company's 1985 average equity base) was allowed as a deduction in calculating the taxable income of each mutual life insurance company in 1986.

Prior to 1981, life insurance companies were not permitted to join in the filing of consolidated income tax returns with affiliated corporations that were not life insurance companies. Thus, income and losses of life insurance companies and affiliated non-life companies could not be used to offset one another. The filing of consolidated returns by life and non-life companies has been permitted since 1981, subject to two restrictions. First, consolidated returns may be filed by a life company and a non-life company only if they have been affiliated for the preceding five years. Second, the amount of non-life losses that can be offset against the income of life companies is limited to the lesser of 35 percent of the non-life losses or 35 percent of the life company income. The latter restriction does not limit the use of life insurance losses to offset income of non-life affiliates.

II. Analysis of the Revenue Effects of Recent Legislation Changing the Taxation of Life Insurance Companies

Revenue estimates generally depend on four factors: (1) the level of economic activity, including both the macro-economic national forecast as well as the market share of the particular economic activity affected; (2) the taxpayers' economic situation, including types of products sold, portfolio choice, and form of organizations; (3) how the specific changes in the tax law affect particular taxpayers' economic situations independent of behavior changes; and (4) how taxpayers react to the tax law changes. If these factors are misspecified or forecasted incorrectly, estimated receipts will differ from actual collections. "Offsetting" errors will often reduce the discrepancy (e.g., an overestimated tax rate may be accompanied by an underestimated tax base), but the chances of this occurring for estimates that affect a specific industry or particular companies are much less likely. As a result of the many different factors involved, it is difficult to estimate accurately the revenue effects of proposed tax legislation.

Estimates of the four revenue estimating factors described above for the life insurance industry were generally based on historical data from tax returns and regulatory data. With respect to the 1982 and 1984 life insurance company tax changes, the data were particularly difficult to interpret for three reasons: (1) the occurrence of significant changes in the insurance industry and its products; (2) the different definitions of the life insurance industry in the available data sources; and (3) the effect of consolidation on life insurance industry tax statistics. The Appendix appearing at the end of this testimony contains a discussion of the data that were available at the time the estimates of the 1984 Act were made.

For the life insurance industry during the 1980's, it has been particularly difficult to estimate revenue changes, because of the changing nature of the industry's products and practices, the limitations of the available information, and the significant tax law changes. The use of modified coinsurance from 1979 to 1981 unexpectedly decreased insurance industry taxes. The explosion of new life insurance products in the early 1980's, the availability of consolidation with non-life insurance companies starting in 1981, and the temporary tax law changes combined with the general economic downturn in 1982-83 made predicting the amount of industry revenues before the 1984 Act changes difficult. Finally, the complete overhaul of the life insurance industry's tax rules in 1984 made estimating the effects on the industry and the consequent tax collections extremely uncertain.

Estimated Revenue Effects at the Time of the 1984 Act

The complete overhaul of the life insurance industry's tax rules in 1984 made it extremely difficult to estimate the revenue effects of specific tax provision changes. Thus, the principal focus of the legislative debate was on the expected receipts from the industry after the tax law changes, rather than the revenue change from the legislation. Nevertheless, estimates by the Treasury and the Joint Committee on Taxation (JCT) of the level of receipts from the industry after the 1984 Act were quite similar. The level of receipts from the life insurance industry after the 1984 Act changes was expected to grow from $3.0 billion in calendar 1984 to between $3.8 and $3.9 billion in 1988, as shown in Table 1. These estimates took into account the effects of consolidation for the life insurance subgroups.

Estimates of the revenues from the mutual and stock segments of the life insurance industry were made for 1984, as shown in Table 2. For calendar year 1984, the total life insurance industry was expected to pay $3.0 billion, with approximately 55 percent paid by the mutual segment ($1.6 billion with rounding) and 45 percent paid by the stock segment ($1.4 billion).

Total Life Insurance Industry Taxes Paid in 1984 and 1985

To obtain information on taxes paid by life insurance companies in 1984 and 1985, the Treasury Department conducted a special survey of life insurance companies. The Treasury Department's survey was sent to the largest (measured by assets) 50 mutual life insurance companies, the largest 198 stock life insurance companies, and a random sample of smaller mutual and stock companies.

Table 3 presents the estimates of taxes paid by the life insurance industry[1] from the Treasury survey in terms comparable to those used in the original estimates of receipts from the 1984 Act shown in Table 2. The life insurance industry paid $2.4 billion in taxes in calendar year 1984, compared to $3.0 billion estimated at the time of the 1984 legislation.[2] The life insurance industry paid $2.9 billion in calendar year 1985, compared to $3.2 billion estimated at the time of 1984 legislation.

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[1] Taxes paid are as reported on Federal tax returns but may differ from actual collections of the Federal government in cases of consolidated returns with non-life losses.

[2] Tax liability generated from life insurance activity may affect tax payments in future years. For instance, the "true-up" for section 809, and the carryover of unused net operating losses and tax credits from 1984 activity affect 1985 tax payments.

Table 1

Treasury and Joint Committee Estimates of Life Insurance
Industry Receipts Before and After the 1984 Act Changes
($ billions)

	Fiscal Year				
	1984	1985	1986	1987	1988
Treasury Estimates					
Baseline Before 1984 Act	3.0	4.0	4.3	4.6	5.0
1984 Act Changes	-0.5	-0.9	-1.0	-1.1	-1.2
Baseline After 1984 Act	2.5*	3.1	3.3	3.5	3.8
Joint Committee on Taxation Estimates					
Baseline Before 1984 Act	3.1	3.5	3.7	4.1	4.4
1984 Act Changes	-0.1	-0.3	-0.4	-0.5	-0.5
Baseline After 1984 Act	3.0	3.1	3.4	3.6	3.9

Department of the Treasury
Office of Tax Analysis

September 1988

SOURCE: Treasury, Office of Tax Analysis and the Joint Committee on Taxation, calculations as of June 1984 at the end of the Conference Committee.

Details may not add due to rounding.

* Difference in FY 1984 estimate from JCT due to Treasury's lower estimate of 1983 CY receipts with the full effect of end of the CY 1982 and 1983 safety net rules shown in the change between FY 1984 and 1985. The Treasury's 1984 calendar year receipts estimate was $3.0 billion.

Table 2

Estimate of Calendar Year 1984 Life Insurance Industry Tax Liabilities After the 1984 Act Changes by Mutual and Stock Segments Made at The Time of the Legislation
($ billions)

	Mutual Life Companies	Stock Life Companies	Total
Gain From Operations 1/	10.7	6.0	16.7
Less: Allowable Policyholder Dividends 2/	5.6	1.7	7.3
Gain From Operations After Policyholder Dividends	5.1	4.3	9.4
Less: Net Operating Loss Deductions	*	0.4	0.4
Less: Small Business Deduction	*	0.2	0.2
Less: Special Life Insurance Deduction	1.0	0.7	1.7
Net Income Less Deficits	4.1	3.0	7.1
Taxable Income	4.2	3.1	7.3
Tax Before Credits	1.9	1.4	3.3
Less: Tax Credits	0.3	0.1	0.4
Tax After Credits	1.6	1.4	3.0

Department of the Treasury
Office of Tax Analysis

September 1988

SOURCE: Office of Tax Analysis August 1984 calculations.

1/ After adjustment for change in reserve deductions.

2/ Estimate of mutual segment's allowable policyholder dividends assumed a $37.4 billion equity base and a 16.5 percent applicable imputed earnings rate.

*Less than $50 million.

Detail may not add due to rounding.

Table 3

Life Insurance Industry 1/ Tax Liabilities for Mutual and Stock Segments for 1984 and 1985
($ billions)

	1984			1985		
	Mutual Life Companies 2/	Stock Life Companies	Total	Mutual Life Companies 2/	Stock Life Companies	Total
Gain From Operations 3/	11.3	10.2	21.5	13.9	11.3	25.2
Less: Allowable Policyholder Dividends	8.0	4.2	12.2	8.7	4.9	13.6
Gain From Operations After Policyholder Dividends	3.2	6.0	9.3	5.2	6.4	11.6
Less: Net Operating Loss Deductions	0.4	1.7	2.0	0.8	1.0	1.8
Less: Small Business Deduction	0.1	0.2	0.2	0.1	0.2	0.3
Less: Special Life Insurance Deduction	0.6	0.9	1.5	0.8	1.2	2.0
Taxable Income 4/	2.3	3.4	5.7	3.4	4.0	7.4
Tax Before Credits 4/	1.0	1.4	2.4	1.4	1.6	3.0
Less: Tax Credits	*	*	0.1	0.1	*	0.1
Tax After Credits 4/	1.0	1.4	2.4	1.3	1.6	2.9

Department of the Treasury
Office of Tax Analysis

September 1988

SOURCE: Preliminary results from 1987 Treasury Department Survey of Mutual and Stock Life Insurance Companies.

NOTE: All figures weighted to estimate industry totals. Figures exclude specially surveyed Canadian-owned companies.

* Not available
1/ Includes companies that file separate, life/life consolidated, or life/nonlife consolidated returns.
2/ Includes stock life insurance company subsidiaries of mutual life companies.
3/ For comparability with Table 3.3, before policyholder dividend deductions and net operating loss deductions and after income offset by nonlife losses.
4/ Taxable income includes mutual segment "true-up" in 1985 of approximately $0.95 billion for an additional $0.35

The taxes paid by the life insurance industry shown in Table 3 are determined on a life subgroup basis, allowing for losses from consolidated non-life companies to offset partially the life subgroup's taxable income and for some reallocation of tax credits between the subgroups. The use of the life subgroup after consolidation basis permits comparison with the revenue estimates made at the time of the 1984 Act. In evaluating the tax rules of life insurance companies, however, it may be appropriate to examine the tax law effects of the life subgroup before consolidation with non-life companies. Estimates of tax liabilities of the life subgroup before consolidation are contained in the Appendix to this testimony.

The shortfall in expected revenues from the life insurance industry in 1984 is largely attributable to an underestimate of $1.6 billion of allowable net operating loss deductions. The shortfall in expected revenues in 1985 is also largely attributable to an underestimate of allowable net operating loss deductions.

The large net operating loss deductions claimed in 1984 and 1985 were an unexpected result of the 1982 Act's temporary relief provisions, the availability of consolidation, and the economic downturn in 1983. The temporary relief provisions removed the limitation on deductions of policyholder dividends contained in the 1959 Act, permitting the accumulation of large net operating losses in 1982 and 1983. According to IRS data, life insurance companies generated $5.5 billion in net operating losses in 1982 and 1983. Before 1980, the largest annual deficit for the industry had been less than $250 million.[3] Almost $4 billion of these net operating losses were carried forward as deductions in 1984 and 1985. Because of normal lags in reporting of tax statistics, this effect of the 1982 Act was not apparent at the time the revenue estimates were made for the 1984 Act.

Gain from operations before policyholder dividends was about $4.8 billion higher in 1984 than projected, but policyholder dividends were $4.9 billion higher. Although these differences offset each other for the industry, they did not for the stock and mutual segments separately, as discussed below. These offsetting differences are largely due to the 1984 Act's change in the definition of policyholder dividends to include any distribution to a policyholder that is the economic equivalent of a dividend. Under the 1984 Act, policyholder dividends specifically include excess interest (i.e., amounts in the nature of interest that are paid or credited to policyholders and are determined at a rate in excess of the rate used under the contract for purposes of computing the company's reserve deduction), premium adjustments, and experience-rated refunds. Because of these changes, gain from operations after policyholder dividends is the most comparable measure of what was projected at the time of the 1984 Act.

Segment Balance Receipts in 1984

The revenue estimates of the 1984 Act projected that the mutual segment of the life insurance industry would pay approximately $1.6 billion in tax and the stock segment would pay approximately $1.4 billion in tax in 1984. Actual collections from the industry in 1984 were $1.0 billion for the mutual segment (or $1.35 billion including the "true-up" for 1984 paid in 1985) and $1.4 billion for the stock segment.

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[3] Department of the Treasury, Interim Report to the Congress on Life Insurance Company Taxation, p. 41.

The stock segment paid approximately the same amount of tax after credits in 1984 as estimated at the time of the legislation. The stock segment's taxable gain from operations after policyholder dividends was $1.7 billion higher than estimated. The stock segment's higher taxable income (net of the special life insurance deduction) was offset almost exactly by the underestimate of its net operating loss deductions.

The mutual segment paid less tax in 1984 than originally estimated at the time of the legislation due to an overestimate of the mutual segment's gain from operations after policyholder dividends. Unlike the stock segment, whose gain from operations before policyholder dividends increased by more than the increase in its policyholder dividends, the mutual segment's gain from operations before policyholder dividends was higher by only $0.6 billion while its allowable policyholder dividend deductions were higher than estimated by $2.4 billion.

Approximately one-quarter of the $1.5 billion overestimate of the gain from operations (after policyholder dividends and the special life insurance deduction) was due to an overestimate of the mutual segment's average equity for purposes of the section 809 policyholder dividend deduction limitation. The 1984 estimates assumed that the mutual segment's average equity base would be $37.4 billion. The actual mutual equity base as reported by the IRS for 1984 was $32.1 billion. The overestimate of the mutual equity base resulted in allowance of approximately $0.4 billion additional policyholder dividend deductions, or approximately $150 million less tax liability, assuming a 36.8 percent marginal tax rate in 1984.

The overestimate of the mutual segment's equity was the result of two factors. First, the estimated equity was based on regulatory data, which differ in scope and measurement from the tax definitions used in section 809. Second, possible tax-minimizing behavior on the part of the mutual segment in reducing their equity as measured for section 809 purposes may have been underestimated.

The mutual segment had an additional tax liability in 1985 due to their lower than expected earnings rate in 1984. The mutual segment had an average earnings rate (i.e., gain from operations after policyholder dividends) of 5.746 percent in 1984. Thus, the recomputed differential earnings rate for 1984 was 10.754, as compared with the statutory 7.8 percent "transition" differential earnings rate for 1984. Consequently, the mutual segment paid a "true-up" rate of 2.954 percent of their 1984 average equity on their 1985 tax returns. The additional taxable income in 1985 from the 1984 "true-up" was approximately $950 million, or an additional $350 million in tax liability, assuming a 36.8 percent marginal tax rate.

Segment Balance Receipts in 1985

The original estimates of the 1984 Act implied approximately $3.2 billion in receipts, $1.7 billion paid by the mutual segment and approximately $1.4 billion paid by the stock segment of the life insurance industry in calendar year 1985. Actual receipts from the two industry segments estimated from the Treasury survey shown on Table 3 indicate the mutual segment paid $1.3 billion ($0.6 billion excluding the estimated $350 million 1984 "true-up" reflected in 1985 returns and the negative $350 million 1985 "true-up" reflected in 1986 returns), and the stock segment paid $1.6 billion.

The stock segment's tax payments in 1985 were higher than in 1984 due to an increase of approximately 10 percent in gain from operations and a $0.7 billion decline in net operating loss deductions. Both the stock and mutual segments realized large amounts of capital gains in 1985 which increased their gains from operations, and their earnings rates for section 809 purposes.

The mutual segment's tax payments in 1985 were lower than estimated due to a smaller gain from operations after policyholder dividends and a larger net operating loss deduction. The mutual segment's gain from operations after policyholder dividends in 1985 was about the same as that projected for it in 1984, and thus none of the expected growth in gain from operations occurred. In addition, the mutual segment's net operating loss deduction increased to $0.8 billion in 1985, when no significant amount of net operating loss deductions by mutual companies was anticipated in 1985. These two differences account for most of the shortfall in expected revenues in 1985.

The mutual segment's gain from operations after policyholder dividends in 1985 of $5.2 billion included approximately $950 million attributable to the "true-up" from 1984 resulting from the higher recomputed differential earnings rate. Thus, approximately $350 million of additional tax liability that was attributable to 1984 activity was paid by mutual companies in 1985. In addition, the mutual companies' 1985 differential earnings rate was calculated as 6.157 percent, but the 1985 recomputed differential earnings rate was only 3.188 percent. Thus, a negative "true-up" rate of -2.969 percent arising from 1985 activity resulted in approximately $950 million less taxable income in 1986. The negative 1985 "true-up" reduced mutual companies' tax liability in 1986 by approximately $350 million. If both the 1984 "true-up" and the 1985 negative "true-up" are excluded from the 1985 figures, the mutual segment's tax liability for 1985 would be $0.6 billion.

After excluding the 1984 "true-up", the mutual segment's gain from operations after policyholder dividends was $4.3 billion in 1985. Like 1984, the mutual segment's gain from operations after policyholder dividends and the special life insurance deduction was overestimated by approximately $850 million. A combination of explanations are possible:

- The activity of the mutual segment was overestimated, possibly resulting from an overestimate of total life insurance activity, the mutual segment's market share of the industry, or the mutual segment's rate of profitability on its life insurance business.
- The equity base of mutual companies in 1985 was overestimated as it was in 1984. The overestimation of the mutual equity base accounts for approximately one-quarter of the difference.
- Taxable gains from operations may have been overestimated by underestimating the companies' tax-minimizing behavior.
- The original estimates underestimated the earnings rates of the stock segment during the 1981-83 period which enter into the calculation of the imputed earnings rate under section 809. The statutory rate of 16.5 percent was thought to be higher than the average earnings rate of the 50 largest stock company groups during the 1981-83 base period. In fact, the average stock earnings rate during the base period was 18.221 percent, which resulted in the 1985 imputed earnings rate (16.323 percent) being lower than the 1985 current stock earnings rate (18.026 percent).

III. Conclusion

The recent changes to life insurance company taxation have resulted in less additional revenue than had been predicted. In particular, the tax payments of the life insurance industry and the relative shares paid by the different industry segments in 1984 and 1985 did not meet Congressional expectations.

Differences between estimated receipts and taxes paid largely reflect the difficulty in predicting accurately life insurance company taxes. Actual income tax collections depend on a number of factors which are difficult to predict accurately, including general macroeconomic conditions and relative market shares of and within the life insurance industry. Moreover, the significant changes in the practices of life insurance companies, their products, and tax rules during the last decade and the inadequacies of available data upon which to base estimates have magnified prediction problems. Thus, the "shortfall" in actual collections does not necessarily imply that the 1984 Act changes have not been effective in taxing life insurance companies more like other corporations.

The Treasury Department believes that it is more appropriate for tax legislation to attempt to measure accurately the economic income of companies than to attempt to collect a particular amount of revenue from an industry or from the different segments of an industry. We intend to continue to evaluate the tax rules affecting life insurance companies and to report to the Congress early next year.

This concludes my prepared remarks. I would be happy to answer any questions.

APPENDIX

Comparison of Tax Liabilities From Different Data Sources

Several measures of tax liabilities of the life insurance industry were available at the time the 1984 estimates were made. The most readily available industry data are from financial statements. However, these data are based upon a definition of the group of companies that comprise the life insurance industry that is different from the tax definition of the life insurance industry. Financial statement information and tax statistics also use different concepts to measure income and taxes. On the other hand, the tax statistics published by the IRS include only partial information regarding the effects of consolidation. As a result of these defects in the available data, the Treasury Department conducted a special survey of life insurance companies to evaluate the taxation of life insurance companies. The Treasury survey was designed to assess accurately the taxes paid by the life insurance industry both before and after consolidation with non-life companies using the tax code's definition of the industry, taxable income, and tax liability.

Table 4 compares preliminary estimates of tax liabilities of the life insurance industry reported on the Treasury's survey with statistics from other sources.[4] The table shows seven different measures of tax liabilities of the life insurance industry in 1984 and 1985. The first three measures in Table 4 are liabilities on life insurance company tax returns as reported in the Treasury survey. These measures use tax return statistics and the tax definition of life insurance companies. The first two survey measures are tax after credits. The only difference between the first two survey measures is the degree of consolidation with non-life companies. The third survey measure is tax before credits. The third survey measure differs from the first two, because it does not include the effects of consolidation or take into account tax credits.[5] In general, "all consolidated companies" includes the effects of income and allowable losses of all companies filing consolidated returns with a life insurance company, and "life insurance subgroup (after non-life losses)" includes the effects of allowable losses of non-life companies filing consolidated returns with a life company. The "life insurance subgroup (before non-life losses)" does not include the effects of allowable losses of non-life affiliated companies.

The fourth measure in Table 4 is the tax after credits of the life insurance industry as reported by the IRS Statistics of Income (SOI) program. This measure is from tax returns, but includes taxes from a different sample of companies. The SOI classifies consolidated returns by industry based on the industry group from which the largest percentage of total receipts is derived. As a result, a significant amount of taxes of life insurance companies included in the Treasury survey measure is not included in the SOI reported total. The SOI data also report bottom-line taxes from consolidated returns. For both 1984 and 1985, the SOI measure of taxes is less than the two tax return measures of taxes from the Treasury survey.

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[4] The Treasury survey requested the latest available tax return information including amended returns as of August 1987. Later amended returns and audit adjustments will result in further changes in tax liability.

[5] Tax after credits was not calculated for the life subgroup (before non-life losses) because the survey collected tax credits used on a consolidated basis.

The fifth, sixth, and seventh measures in Table 4 report annual financial statement taxes. The fifth measure in Table 4 presents the financial statement measure of taxes paid by the life insurance industry in the Treasury survey. This measure is based upon a sample of life insurance companies consistent with the tax law, but taxes reported on financial statement are higher than taxes reported on tax returns by the same companies due to differences in financial and tax accounting. The final two measures are reports of financial statements taxes from A.M. Best's Aggregates and Averages and from the American Council of Life Insurance's Life Insurance Fact Book. These latter two measures are based on samples of life insurance companies' regulatory statements.

Taxes reported on financial statements are generally higher than tax return measures for several reasons. Tax liabilities are measured differently for tax and financial reporting purposes. Financial statement amounts are estimates of tax liabilities that are made several months before a company files a tax return. The taxes reported on financial statements may include amounts never reported on tax returns, such as assessed tax deficiencies relating to audits of prior year tax returns. Where financial and tax accounting differ on the timing of income recognition, the financial statement taxes may include amounts that are not actually paid to the Treasury until later years due to tax deferral. In addition, the regulatory statements do not allow consolidation with non-life companies, although life insurance companies have been allowed to file consolidated tax returns with non-life companies since 1981.

Table 4

Comparison of Measures of Tax Liabilities of Life Insurance Companies
From the Treasury Department's Survey, SOI Tax Statistics, and
Financial Statements for 1984 and 1985
($ millions)

	1984			1985		
	Mutual Life Companies	Stock Life Companies	Total	Mutual Life Companies	Stock Life Companies	Total
Tax Return Measures						
Treasury Survey						
All Consolidated Companies	891	1,467	2,357	1,211	1,542	2,754
Life Subgroup (after non-life losses)	974	1,426	2,400	1,282	1,601	2,883
Life Subgroup (before non-life losses) 1/	1,083	1,759	2,842	1,482	2,119	3,601
SOI Tax Statistics	704	558	1,262	914	1,341	2,256
Financial Statement Measures						
Financial Statements from Treasury Survey	1,212	1,643	2,855	2,080	2,270	4,359
Financial Statements from A.M. Best	1,231	1,525	2,756	2,084	2,049	4,133
Financial Statements from ACLI	N/A	N/A	2,785	N/A	N/A	4,134

Department of the Treasury
Office of Tax Analysis

September 1988

SOURCE: Preliminary results from 1987 Treasury Department Survey of Mutual and Stock Life Insurance Companies, Internal Revenue Service Corporation Source Book of Statistics of Income, A.M. Best Aggregates and Averages Life-Health 1986, and American Council of Life Insurance Life Insurance Fact Book.

NOTE: All figures weighted to estimate industry totals. Figures exclude specially surveyed Canadian-owned companies.

N/A = Not Available.

1/ Amounts shown are tax before credits.

Chairman RANGEL. Thank you. On May 12, I sent a letter to Treasury, and I suggested that when Treasury prepared its final report, in addition to the issues that Treasury covered in the analysis, that they consider for discussion, one, the tax policy issues surrounding a specified segment balance; two, the theories propounded by portions of the industry; three, the impact of consolidation and the updated review data.

I am wondering now whether or not in January, or whenever the report is ready, whether or not those would be incorporated in the report?

Mr. NEUBIG. We plan on looking at the whole issue of Section 809 and the segment balance issue, as well as consolidation. We have already presented the numbers for 1984 and 1985. We will present published numbers for 1986 which was required by Congress, but we do not plan on doing a special survey for the calendar year 1986 data. But we do plan on covering those topics in our final report.

Chairman RANGEL. Well, as you know, that while we are not doing anyhing this year, we are not really satisfied with the final conclusions that we came up with. It was, and I think Treasury would agree, and certainly the industry did, that was the best we could do at the time. Estimates were made and I think, for the most part, they were accurate, but it's not a piece of tax work that any of us feel proud about. And so, therefore, I think it's incumbent upon the Treasury Department to give us the best possible data as we try to draft something that is fair to the industry, fair to the taxpayers, and fair to our country.

And even though we may not follow those recommendations, I think that most of the expertise should lie in Treasury, and we will be depending upon you and, fortunately, I think you have a sufficient amount of time, and since sometime we will be out of session, you can spend more time back at the office than on the Hill.

I thank you for your testimony, and ask whether there's any members at this point seeking recognition.

We hope to be working very closely with you, and we thank you so much for your testimony.

Mr. Downey is not a member of the committee, but he has some questions he wants to ask.

Mr. DOWNEY. Thank you. Mr. Chairman, can I ask the Treasury, you stated before, I think in the course of your remarks, that you thought that the measuring of economic income was the best way to do that.

Do you think that in the next couple of months that you're going to be able to figure out a way to do that?

Mr. NEUBIG. I think we can review the attempt that was made in 1984, and certainly make some proposals for refinements.

Mr. DOWNEY. When do you think you'll be able to make it.

Mr. NEUBIG. Well, we're trying to have the report done in this Administration. And so we're shooting for January.

But measuring of economic income of mutual companies is very difficult. The Congress struggled and Treasury struggled with that in 1984. I think we do want to review the new thinking in this area that has occurred over the last 4 years. If we do decide that some type of Section 809 limitation on mutual companies' policyholder dividends is still appropriate, we certainly would want to review the operation of that provision to see if it could be simplified and made more administrable.

Mr. DOWNEY. Mr. Chairman, if I could ask one more question.

A number of us who voted for the 1986 tax revision are on more than one occasion embarrassed by the Citizens for Tax Justice who wave around their reports and say that corporations don't pay any taxes.

And as I understand it, one major life insurance company, Aetna, had substantial income in their financial statement but managed to pay no taxes.

Could you tell me how that happens?

Mr. NEUBIG. We haven't reviewed the McIntyre report, and certainly——

Mr. DOWNEY. Can you give me a guess of how you think it might happen? I mean if you were an insurance company trying to zero your taxes, how would you do it? [Laughter.]

Mr. NEUBIG. I would be working for the private sector if I could zero, zero, zero all the people's taxes. [Laughter.]

Mr. DOWNEY. And I'm sure one day you may return.

Mr. NEUBIG. There are a number of possibilities. I would hope that the 1984 tax changes for the life insurance companies have significantly broadened the tax base of the life insurance companies and the alternative minimum tax enacted in the 1986 Tax Reform Act would prevent that type of situation.

I know that report has sparked a lot of interest. I think we need to see whether or not it's accurate.

Mr. DOWNEY. Well, I would hope that you would review it because it appears to me that some companies can pursue strategies that—solve the Nation's strategies that can offset losses from one affiliated group to the other. And I don't think that's what we had in mind either in the 1984 act or the 1986 act.

Mr. NEUBIG. Well, you can't look just at 1 year's worth of income. I think that is a lesson we've learned from the 1984 act changes. Net operating losses from other years can significantly change the timing of tax liability.

The operation of the Section 809 has differential timing effects as a result of its complicated nature. It can significantly increase a company's tax liability, let's say, in 1986, and essentially force a company to prepay taxes, and then it would have significantly lower taxable income and possibly even a refund in 1987. That could occur as a result of a normal operation of the current tax rules. I would not see any problem on the part of the companies if NOL's or section 809 were causing the 1-year effect.

Mr. DOWNEY. Thank you, Mr. Chairman.

Chairman RANGEL. Thank you very much.

Mr. COYNE. Mr. Chairman, I have one question.

Chairman RANGEL. Mr. Coyne.

Mr. COYNE. What is the current tax rate for mutual and stock companies, and how does that compare with the current corporate rate?

Mr. NEUBIG. The statutory rate is exactly the same in terms of the top——

Mr. COYNE. And what is that?

Mr. NEUBIG. The top statutory rate is 34 percent.

You probably have seen effective tax rate numbers which take total taxes paid in a given year and divide that by financial statement income. That can lead to very misleading results, and especially in the case of mutual companies where we do not have a good measure of their income. The effective tax rate could be significantly lower than 34 percent or could even be significantly higher than 34 percent as a result of just the timing of the tax payments.

Mr. COYNE. Have you got any indication from your studies just where that falls in practice?

Mr. NEUBIG. The 1984 act significantly raised the effective tax rates of life insurance companies over what it would have been if the 1984 act hadn't changed. We have not tried to quantify that.

When we do the section 809 study and try to get a better measure of economic income, I think we would feel more comfortable with doing an effective tax rate measure, but we haven't done one at the current time.

Mr. COYNE. Thank you.

Chairman RANGEL. Do you have other examples in Treasury where one part of the industry's tax liability is based on the success or lack of it of another segment of that industry?

Mr. NEUBIG. I'm not aware of any.

Chairman RANGEL. And I guess you agree that there is a need for us to come up with a better solution than that what we have now, do you agree?

Mr. NEUBIG. We believe that section 809 should be thoroughly reviewed, and depending upon the results of the final Treasury report, changes should be made.

Chairman RANGEL. OK. Well, you have done very well your first time out. [Laughter.]

And I don't know—but you will be around probably next year, but a lot of other people won't.

Mr. NEUBIG. I look forward to it. [Laughter.]

Chairman RANGEL. We have the General Accounting Office. Jennie Stathis, Associate Director, General Government Division, and we have our old friend, Natwar Gandhi, who is the Group Director of Tax Policy.

Good seeing you again, Mr. Gandhi, and welcome, Ms. Stathis.

Your full statement will be entered into the record and you can proceed as you find most comfortable.

STATEMENT OF JENNIE S. STATHIS, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY NATWAR M. GANDHI, GROUP DIRECTOR, TAX POLICY; AND TOM McCOOL, ECONOMIST

Ms. STATHIS. Thanks very much. We are pleased to be here this morning to participate in your hearing.

Let me introduce another member of my team. This is Tom McCool, who is an economist on our staff working with Dr. Gandhi, who did much of the analysis that we will be presenting today.

Chairman RANGEL. Welcome.

Ms. STATHIS. Mr. Chairman, you and Mr. Stark, as chairman of the Subcommittee on Health, asked us to gather data on the taxes paid by the life insurance industry for 1984, 1985, and 1986. And yesterday we issued a report addressing your concerns. Hopefully you all have copies of this. It has the statistics that we gathered.

Much of my testimony today will be based on that report.

You also asked us to evaluate the section 809 mechanism, and we are proceeding to do that. We have not completed that work. We also hope to finish our work early next year, at about the same time as the Treasury Department.

In terms of background, I will skip through my statement rather than reading the entire statement.

The 1984 act, as you alluded to earlier, changed the way that life insurance companies were taxed. The most important change was to do away with the distinction between investment income and underwriting income that had been embedded in the 1959 act. The intent of the 1984 act is to tax life insurance companies in a way that parallels the taxation of other companies. This means taxing all gains from operations without distinguishing between sources of income. Mutual companies are a very important part of the industry and the problem arose as to how they should be treated under the 1984 act.

The income of stock companies consists of dividends paid to shareholders and earnings that are retained by the company. Mutual companies also add retained earnings to their surplus, and this addition is classified as taxable income. However, the dividends they pay to their policyholders who are the owners of mutual companies are not so easily categorized. The difficulty is in disentangling the part of policyholder dividends that is income to the mutuals from the other elements which are not income, but return of excess premiums.

And section 809, as you alluded to, was an attempt to calculate the income for the mutual segment. In effect, a return on equity is imputed to the mutual segment based on the performance of the stock segment.

Based on this imputed rate and the average earnings rate of the mutual segment, each mutual company must include in taxable income an amount that represents the part of policyholder dividends that is paid out as earnings. The intended effect is to treat the policyholders of mutual companies as if they are shareholders for corporate tax purposes.

Now, our analysis shows that the total taxes incurred by the industry over the 3-year period, 1984 through 1986, exceeded the revenue estimates made by the Joint Committee on Taxation before the 1984 act was passed. In 1984, the life insurance industry incurred $2.8 billion in taxes, slightly less than the $3 billion revenue estimate, but in 1985 and 1986 the taxes incurred were $1 and $1.3 billion greater than the respective estimates. This was largely attributable to high capital gains income in those years resulting from favorable stock market performance followed by large sell-offs of securities preceding the 1987 increase in the corporate capital gains tax rate.

The segment balance, however, did not split as expected. When the 1984 act was passed, Congress expected that the mutual companies would pay 55 percent of the tax burden, and that stock companies would pay 45 percent. In fact in 1984, the balance was virtually reversed. In 1985 and 1986, the taxes were more evenly split.

As Mr. Neubig has indicated, these statistics vary from the Treasury numbers. The statistics that we have in our report come from financial statements that the companies reported to State regulators as reported by A.M. Best. The Treasury acquired its data by asking a sample of more than 300 companies the amount of taxes they actually paid that year. And these statistics will always vary. I am not as certain as Mr. Neubig, however, that his survey statistics are the only reliable measure because, as he alluded at the end of his testimony, any one year's tax in this industry is very difficult to measure. There are changes across years so that the statistics that companies gave him for a particular year may be somewhat misleading.

If you look at the industry over a longer term, you probably have a better perspective.

Our figures also don't reflect consolidation with nonlife insurance companies. Depending upon how you want to approach that subject, you will come to different results. We felt that to adequately represent the tax burden of the life insurance industry, it was better to report the figures without consolidation.

In addition, we have some preliminary data today that's not in the report you have. The data is on 1987 taxes for the mutual segment.

Our data indicates that the taxes of the mutual segment will likely decrease. We base our observation on the following:

First, data obtained for a sample of the largest 28 mutual companies indicates that operating income for 1987 was comparable to 1986, while capital gains income fell.

Second, Treasury's recently announced differential earnings rate which will be applied against the 1987 year is the lowest in this 4-year period. As a result, we think logically, that will produce low earnings and low taxes from the section 809 computation.

And, third, due to the difference between the estimated and actual earnings rates, the recomputation of 1986 taxes, which will be reflected on 1987 returns, will result in a large refund for the mutuals, close to $1.5 billion.

Thus, while the available data is not sufficient for us to say precisely what the taxes will be in 1987, they point directly to lower taxes.

Similarly, in the 1984 through 1986 period, the mutual segments' portion of taxes on income from operations was less than expected because its share of income from operations was lower. This income, before deducting policyholder dividends or taxes, fell from 57 percent of industry income in 1984 to 52 percent of industry income in 1986. And measured after policyholder dividends but before taxes, the mutual share declined from 32 percent to 17 percent.

So, whether this weakening in the income position of the mutual segment represents a long-term trend, or whether it is simply an aberration is difficult to judge over such a short period. However, we noticed that in many other categories, the movement for the mutual segment was downward as well.

In the last part of my statement, I discuss the evaluation of section 809. We are proceeding with that. We have not yet completed it. We note there that if you evaluate the 1984 act and the segment balance mechanism on the basis of the 55/45 split between the segments, then obviously it was not successful. If you measure its success, however, on whether the mutual stock breakdown of taxes was consistent with their breakdown of income, you might come to a different result. If it is based upon calculating mutual income as section 809 specifies, you will come to the conclusion that the taxes were consistent with the segment balance of income.

Regardless of the breakdown of taxes between the two segments, there are still some potential problems with the section 809 method. Among the issues that we are studying is whether section 809 leads to inequities for the mutual segment on a year-to-year basis. The additional tax imposed is based on the difference between the imputed rate of return and the average mutual rate of return on equity.

As a result, in years when the mutual segments' earnings rate is below its historical average, section 809 will have the firms in the segment add a larger amount to their taxable income than in years when their performance is above average. The mutuals are taxed as if they are paying out more earnings when they perform poorly than when they perform well.

Another issue is whether the mechanism imposes a regressive tax burden on a company-by-company basis. In other words, do mutual companies with lower earnings pay a higher proportion of their income in the form of the extra tax? Because section 809 uses averages in its computations, the companies pay taxes on the basis of what the average stock and the average mutual company earn. Thus, companies with below average earnings may be "overtaxed," and companies with above average earnings "undertaxed."

A third issue relates to the use of an average mutual earnings rate in which the average is weighted by company equity. If the larger mutuals pay out above average policyholder dividends, the weighted average earnings rate will be pushed down substantially. The result is that the average extra tax will be higher for all the firms in the segment. The decisions of one set of firms—in this case, the larger mutuals—could affect the taxes paid by another set—in this case all the other mutuals.

Another potential problem involves using the stock company as a model for taxing mutual companies. If the mutual companies are not as cost conscious, or if they are more adverse to risk taking, on average they will earn lower returns on equity than stock companies. In this case, imputing taxable income to the mutuals on the basis of stock company performance would result in overtaxing the entire mutual segment.

Along with the problems that we are evaluating now in terms of specific data to see if in fact those problems turn out to be real problems, we are also evaluating several alternatives that have been suggested by other people as a way of better measuring mutual income. One alternative is that mutual firms would not be taxed on any part of policyholder dividends because they are presumed to have prepaid the tax due on those dividends when the excess premium was initially included in underwriting income.

Another approach would use a different basis for imputation than the stock segment. It would use the return on an alternative asset, such as the tax-free bond as the basis for imputation.

A third alternative would exclude a stated proportion of dividends from the allowable deduction.

In summary, our report indicates that the taxes incurred by the industry did not split in the expected ratio. In general, the mutual segment incurred a smaller proportion of taxes than had been expected. But the proportion of each segment's taxes was consistent with the proportion of each segment's income.

When we have completed our evaluation, we will be reporting to the subcommittee. Hopefully that will be early next year.

And that concludes my statement. We will be happy to try to respond to your questions.

[The statement of Ms. Stathis follows:]

TAXES INCURRED BY, AND BUSINESS TRENDS OF, THE LIFE INSURANCE INDUSTRY

SUMMARY OF STATEMENT BY
JENNIE S. STATHIS
ASSOCIATE DIRECTOR
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

The Deficit Reduction Act of 1984 changed the way that life insurance companies are taxed. The act tries to tax life insurance companies in a way that parallels other companies. Defining income for stock life insurance companies is not very difficult, but mutual companies present a special problem. The problem is to measure the part of policyholder dividends that represents a payout of earnings by a mutual company versus the part that represents a refund of excess premiums paid by the policyholder. Section 809 of the Internal Revenue Code imposes a method for reducing the amount of policyholder dividends that mutual life insurance companies are allowed to deduct.

For the period 1984 through 1986, as a whole, taxes incurred by the life insurance industry were somewhat greater than expected. In 1984 taxes incurred were $2.8 billion, while the revenue estimate was $3 billion. For 1985 and 1986 taxes incurred exceeded the revenue estimates by $1.0 and $1.3 billion. Much of this was due to large capital gains realizations, especially in 1986. The mutual segment paid less than the 55 percent of industry taxes that was estimated in 1984, but not necessarily less than the proportion that mutual company income represented of industry income.

The mutual share of many important industry variables, such as assets and capital and surplus, declined from 1984 through 1986. However, the mutual share of insurance in force, premium income, and new insurance issued increased slightly during the period.

We are continuing a study of section 809 to see whether it has achieved the goal of equitably allocating taxes between the segments (segment balance) and among firms within the mutual segment. Our analysis focuses on certain issues, such as the allocation of taxes on a company-by-company basis, that arise regarding section 809. We are also examining alternatives to the segment balance mechanism, such as using an imputed rate from outside the life insurance industry or designating a proportion of policyholder dividends to be included in taxable income.

Mr. Chairman and Members of the Subcommittee:

We are pleased to have the opportunity to help in your hearing on the amount of taxes paid by the life insurance industry and how these taxes are allocated within the industry.

Mr. Chairman, you and the Chairman of the Subcommittee on Health of the House Committee on Ways and Means asked us to gather data on the taxes paid by, and business trends of, life insurance companies for 1984, 1985 and 1986. Yesterday we issued a report addressing your request.

You also asked us to evaluate the segment balance mechanism in section 809 of the Internal Revenue Code, which tries to maintain a specific distribution of the life insurance industry tax burden between the stock and mutual segments of the industry. We are now completing that evaluation in which we are exploring questions raised by the existing mechanism and examining alternative approaches to segment balance that have been suggested.

Before I discuss the industry data in our report and our ongoing analysis of section 809, I would like to provide some background on life insurance taxation.

TAX LAWS AND THEIR EFFECTS ON THE STOCK-MUTUAL COMPANY BALANCE

For over two decades the legislation that controlled the taxation of life insurance companies was contained in the Life Insurance Company Income Tax Act of 1959. This act was oriented to the industry as it was then structured. Some of the industry's important characteristics included: (1) the dominance of the mutual segment as measured by items such as insurance in force and assets, (2) the importance of whole life policies which generated large reserves and investment income, and (3) a moderate rate of inflation, compared to much higher rates in the 1970s and early 1980s. In addition, the law made special provision for the long-term nature of the life insurance business and attempted to foster the survival of small life insurance companies.

After passage of the 1959 act, changing economic conditions--particularly higher interest rates--raised doubts about the appropriateness of certain of the act's provisions. Many insurance companies used various provisions in the law, especially distinctions between types of income, to reduce their taxes. In addition, the balance of the industry between stock and mutual companies was changing, and mutuals no longer dominated all areas. The lines of insurance written by companies shifted from whole life to an increasing reliance on term and group insurance. As a result, Congress saw a need to change the tax treatment of life insurance.

The Deficit Reduction Act of 1984 changed the way that life insurance companies were taxed. The most important change was to do away with the distinction between investment income and underwriting income embedded in the 1959 act. The intent of the 1984 act is to tax life insurance companies in a way that parallels the taxation of other companies. This means taxing all gains from operations without distinguishing between sources of income.

Mutual companies are still a very important part of the industry, and the problem arose as to how they should be treated under the new law. The income of stock companies consists of dividends that are paid to shareholders and earnings that are retained by the company. Mutual companies also add retained earnings to their surplus, and this addition is classified as taxable income. However, the dividends they pay to their policyholders, who are the owners of the mutual companies, are not so easily categorized. The difficulty is disentangling the part of policyholder dividends that is income to the mutuals (a return on equity) from the other elements which are not income (a return of excess premiums).

Section 809 of the Internal Revenue Code imposes a method for reducing the amount of policyholder dividends that mutual life insurance companies are allowed to deduct. In effect, a return on equity is imputed to the mutual segment of the industry based on the performance of the stock segment. Based on this imputed rate and the average earnings rate of the mutual segment, each mutual company must include in taxable income an amount that represents the part of policyholder dividends that is paid out as earnings. The intended effect is to treat the policyholders of mutual companies as if they are shareholders for corporate tax purposes.

INDUSTRY DATA

In brief, our analysis shows that the total taxes incurred by the industry over the three year period (1984-1986) exceeded the revenue estimates made by the Joint Committee on Taxation before the 1984 act was passed. However, our analysis also shows that the taxes incurred did not split into the ratio Congress had envisioned--55 percent for mutual companies and 45 percent for stock companies.

In 1984 the life insurance industry incurred $2.8 billion in taxes, slightly less than the $3.0 billion revenue estimate. However, the 1985 and 1986 taxes incurred were $1.0 and $1.3 billion greater than the respective revenue estimates. This was largely attributable to high capital gains income in those years resulting from a favorable stock market performance in the mid-1980s, followed by large sell-offs of securities preceding the 1987 increase in the corporate capital gains tax rate.

The segment balance, however, did not split as expected. In fact, in 1984 the balance was virtually reversed from that expected, with stock companies incurring 56 percent of the taxes and the mutual segment accounting for 44 percent. In 1985, the mutual segment accounted for 49 percent and, in 1986, for 51 percent.

The Treasury Department has also studied the effect of the Deficit Reduction Act of 1984 on the taxes paid by mutual and stock companies. Treasury acquired its data by asking the companies what amount of taxes they paid. Our data came from financial statements filed with state regulators, as reported by A.M. Best. Thus, our figures may differ from Treasury's. Regardless, both studies tell the same story--the mutual segment of the industry did not pay as high a proportion of taxes as Congress envisioned when the bill was enacted.

In addition, preliminary data indicates that the taxes of the mutual segment will likely decrease for 1987. We base this observation on the following. First, data obtained for a sample of the largest 28 mutual companies, which held roughly 90 percent of the mutual segment's assets, indicates that operating income for 1987 was comparable to that for 1986 and that capital gains income was substantially less than for 1986. Second, Treasury's recently announced differential earnings rate--to be applied in making the initial 1987 computation under section 809--is the lowest for the four-year period. As a result, it will logically produce low earnings and taxes from the section 809 computation. Third, due to the difference between the estimated and actual earnings rate, the recomputation of 1986 taxes--to be reflected on 1987 returns-- will result in a large refund--close to $1.5 billion. Thus, while the available data is not sufficient to precisely calculate the taxes for 1987, it points directly to lower taxes for the mutual segment.

Similarly, in the 1984-1986 period, the mutual segment's portion of taxes on income from operations was less than expected because its share of income from operations was lower. This income, before deducting policyholder dividends or taxes, fell from 57 percent of industry income in 1984 to 52 percent of industry income in 1986. Measured after policyholder dividends but before taxes, mutuals' income declined from 32 percent of the industry total in 1984 to 17 percent in 1986.

Whether this weakening in the income position of the mutual segment represents a long-term trend or whether it is simply an aberration is difficult to judge over such a short period. However, in many other categories the movement for the mutual segment was downward as well. For instance, the mutual proportion of total industry assets, capital and surplus, and investment income all moved downward from 1984 through 1986.

In contrast, insurance in force and premium income, a level proportion during 1984 and 1985, rose slightly in 1986. New insurance issued rose slightly as a proportion of the totals for the industry in each year. Even with this improvement, the mutual segment only wrote about 38 percent of the new insurance in the industry in 1986.

During 1984 through 1986, the composition of asset portfolios changed very little. Bonds continued to be the largest component of assets for stocks and mutuals, though they were more important for stocks. Mutual companies held a slightly higher proportion of their assets in the form of mortgage loans and real estate than did stock companies. Policy loans continued to be more important for mutual than for stock companies though they were not a large part of either segment's assets. For each of the three years, the yield on admitted assets--those permitted by state regulators in determining a company's financial condition--was lower for mutuals than for stocks.

EVALUATION OF SECTION 809

We are also evaluating how well the segment balance mechanism works. Although we have not yet reached final conclusions, our preliminary analysis has led us to some tentative observations.

The industry data indicate that if segment balance is evaluated in terms of a 55/45 mutual-stock breakdown, segment balance was not achieved over the 1984 through 1986 period. If, however, segment balance is evaluated by whether the mutual-stock breakdown of taxes is consistent with the mutual-stock breakdown of income, the conclusion might be different. For the period 1984 through 1986, the segment balance of taxes appeared consistent with the segment balance of income as computed using section 809.

Regardless of the breakdown of taxes between stocks and mutuals, there are still potential problems with the section 809 method. Among the issues that we are studying is whether the section 809 mechanism leads to inequities for the mutual segment on a year-to-year basis. The additional tax imposed by section 809 is based on the difference between the imputed rate of return and the average mutual rate of return on equity. As a result, in years when the mutual segment's earnings rate is below its historical average, the section 809 mechanism will have the firms in the segment add a larger amount to their taxable income than in years when the mutual performance is above average. The mutuals are taxed as if they are paying out more earnings to their policyholders when they perform poorly than when they perform well.

Another issue is whether the mechanism imposes a regressive tax burden on a company-by-company basis. In other words, do mutual companies with lower earnings pay a higher proportion of their income in the form of the extra tax imposed by section 809? Because section 809 uses averages in its computations, companies pay taxes on the basis of what the average stock and the average mutual company earn. Thus, companies with below average earnings may be "overtaxed" and companies with above average earnings "undertaxed".

A third issue relates to the use of an average mutual earnings rate in which the average is weighted by company equity. If the larger mutuals pay out above average policyholder dividends, the weighted average earnings rate will be pushed down substantially. The result is that the average "extra" tax imposed by section 809 will be higher for all the firms in the segment. The decisions of one set of firms--in this case the larger mutuals--affect the taxes paid by another set--in this case all the other mutuals.

Another potential problem with section 809 involves using the stock company as a model for taxing mutual companies. If mutual companies are not as cost-conscious as stock companies, or if mutuals are more averse to risk-taking, on average they will earn lower returns on equity than stock companies. In this case, imputing taxable income to mutuals on the basis of stock company performance would result in overtaxing the entire mutual segment.

In addition to examining issues regarding section 809, we are also analyzing a range of alternatives to the 809 procedure.

-- Under one suggested alternative, mutual firms would not be taxed on any part of policyholder dividends because they are presumed to have prepaid the tax due on those dividends when the excess premium was initially included in underwriting income.

-- Another approach would use a different basis for imputation than the stock segment's return on equity. It would use the return on an alternative asset, such as a tax-free bond, as the basis for imputation.

-- A third alternative would exclude a stated proportion of policyholder dividends from the allowable deduction.

SUMMARY

In sum, our report indicates that the taxes incurred by the industry did not split in the expected ratio. In general, the mutual segment incurred a smaller proportion of taxes than had been expected in 1984. But the proportion of each segment's taxes was consistent with the proportion of each segment's income. Currently we are evaluating the section 809 mechanism as well as alternatives to that mechanism. We hope to report to you on our results next year.

This concludes my prepared statement. We would be pleased to respond to any questions.

Chairman **Rangel**. Thank you. In next year's report, will you be exploring in greater depth the alternative to the existing law?

Ms. **Stathis**. That's correct, and to see if they are an improvement. They may not be an improvement. They are just alternatives that have been offered.

Chairman **Rangel**. And even though you reach different conclusions from Treasury, and you said that was in part due to the different methods in which you collected your data, is it safe to assume that that is the basis of the difference and that you don't take issue with the results of Treasury's, just that you pursued different methods of getting tax information?

Ms. **Stathis**. That's correct. We don't take issue with the Treasury's statistics. We have not reviewed them in any great depth, but I don't take issue with them. In fact, I think it's fairly amazing that the numbers are as consistent as they are.

Chairman **Rangel**. It has been brought to my attention that some of the companies that you used, the Treasury did not use because they did not do enough insurance business.

Do you think that would affect the data in terms of reports?

Ms. **Stathis**. To a very small extent. The A.M. Best data reports some companies that are life insurance companies but, for tax purposes, are not taxed as life insurance companies. And we have estimated that they might have made a half a percent difference in the mutual segment, and I think it was about 2 to 3 percent difference in the stock segment. So it was a very minor impact, not really significant.

Chairman **Rangel**. You pointed out the inequities of the formula which we legislated.

Do you know of other examples in your research where one segment of an industry is taxed based on the results of another part of the industry?

Ms. **Stathis**. We know of no similar case.

Mr. **Gandhi**. But I think we need to elaborate a little on that, Mr. Chairman. Very rarely do you have two segments of industry competing as bitterly as they do among themselves. So there is a problem of the competitive balance between the two.

Ms. **Stathis**. It's also a fairly unique situation that you have a mutual company in this kind of business where its income is so difficult to measure. So I think that the result that Congress came to in 1984 is easy to understand given the complexities of adequately measuring taxable income.

Mr. **Gandhi**. And this problem has plagued the industry and the Congress ever since 1909. Always there has been a problem of how much policyholder dividends we need to include in taxable income.

Chairman **Rangel**. And, Mr. Gandhi, do you think we are any closer of getting a more equitable solution to the problem now that we've had a chance to review this latest attempt by the Congress and the industry?

Mr. **Gandhi**. Well, I would say the 1984 act was a major step indeed in making sure that both segments of industry are taxed equitably. As Ms. Stathis has pointed out, we are going to examine other alternate views and how we might improve the taxation of the mutual companies.

But I really do not think that there will be a precise solution to this whole problem.

Chairman **Rangel**. Mr. Coyne.

Mr. **Coyne**. I have no questions.

Chairman **Rangel**. Mr. Downey.

Mr. **Downey**. Thank you, Mr. Chairman.

I think that part of this mirrors what my constituents think about taxes, that those who earn less pay more, and those that earn more pay less. It's kind of an interesting way to tax people.

From the statistics that I've seen in the GAO report, I would like you to comment on the idea of the segment balance which is, I think, a 55/45 standard that was set out for mutual and stocks.

Is it fair to assume that the stock companies are just a bigger force in the industry today than they've been in the past in terms of the premium life insurance in force? I mean is that a reading of your data?

Ms. **Stathis**. Our data suggests that the mutual companies are staying fairly stable while the stock companies are growing. As a result, the proportion is changing.

Mr. **Downey**. Well, wouldn't that normally reflect itself, or shouldn't it, in terms of their tax liability?

Ms. **Stathis**. That's why we say in our statement that if you measure the taxes paid on the basis of the segment balance of income, you will conclude that it was proportionate although it did not match the 55/45 split that had been anticipated when the act was passed.

Mr. **Downey**. In terms of when you estimate the tax from mutuals that in terms of the equity base from which you measure it, I mean are you confident that there wasn't any overestimate or any changes that might have resulted in a higher tax for them than they should have paid? I'm concerned about the Treasury numbers more than I am GAO.

Mr. **Gandhi**. Well, let me elaborate on that. Historically, the large mutuals have held a large amount of assets. They still do today. The Congress decided to split the segment balance on the basis of assets. As early as 1959, Congress decided that mutuals were going to pay 65 percent, stocks 35 percent.

And then that element of mutuals expected to pay higher taxes carried on all the way up to 1984, when it was decided that mutuals were going to pay roughly 55 percent and stocks 45 percent.

But, as Ms. Stathis pointed out, the actual development and the texture of the business in terms of insurance in force, new insurance issued, and premium income has dropped. All of those trends suggest that stocks are the growing element of the industry, not the mutuals.

There is this fundamental fact that mutuals are indeed stagnant when you compare their business with stocks. And that is what really leads to the lower income and lower taxes by mutuals.

Mr. **Downey**. So that assuming that we move at some time in the future for an economic income formula based on some of the suggestions that you have made—might I ask you to send us your ideas? Does Treasury regularly, routinely review your report since they haven't looked at January 20? I hope they come up with something. I hope that they listen to the debate here in terms of this idea, because it seems to me that this is really a harebrained system of taxation. One segment of an industry is taxed. On the other, regardless of how bitterly competitive they are, it doesn't make a great deal of sense. And I hope in the future you can find a more equitable way of taxation.

Mr. **Gandhi**. Well, we do work with Treasury in that we exchange ideas. And we also talk regularly with industry as well so that a proper and equitable manner of taxation is designed.

Mr. **Downey**. Thank you.

Chairman **Rangel**. Mr. Stark, the GAO has just completed their testimony if you would like to inquire.

Mr. **Stark**. Thank you, Mr. Chairman.

I will pass. I want to thank the GAO, which has always served this committee, for being on the straight and narrow and give us excellent technical assistance in this very complex area.

Mr. Gandhi and his staff are to be particularly commended. We've been at this for a long time, and they have been very helpful. Their reputation is excellent, and I thank them for their good work.

Ms. **Stathis**. We thank you for your comments.

Chairman **Rangel**. I join with Chairman Stark and thank you for being with us. And as Mr. Downey has said, it would be helpful if we didn't treat Treasury and GAO as two separate entities. It's the same problem, and we will finally have to come up with a solution, and we hope that it's not a political solution.

Mr. **Gandhi**. Thank you, sir.

Chairman **Rangel**. Professor Andrew Pike, American University, Washington College of Law.

Thank you for joining us, Professor. We have your testimony. Without objection, the entire statement will be entered into the record, whether it's tables, and you may proceed.

STATEMENT OF ANDREW D. PIKE, PROFESSOR OF LAW, AMERICAN UNIVERSITY, WASHINGTON COLLEGE OF LAW

Mr. **Pike**. I have some good news for you today. I do not have any revenue numbers. [Laughter.]

I would also like to state the capacity in which I come before you today, and that is as a sacrificial lamb. Many people today would say that they would be the last person to ever defend section 809. I think I'm literally that last person.

I would like to give some history and explain the problem that section 809 deals with, and the problem that you will have to struggle with. It's an extremely difficult one.

First, I would like to turn back to the years before 1984. Today, most people would agree that mutual companies are taxed in a very, very bizarre fashion. Before 1984, all life insurance companies were taxed in a very, very bizarre fashion. The treatment of life insurance companies enacted as part of the 1984 act was a significant achievement because, for the first time, it taxed stock life insurance companies in a sensible manner. This was one of the primary goals in 1984.

The goal of the staff working on this project was to level the playing field. That's a nice platitude. What does it mean? We were trying to see if life insurance companies could be taxed on their economic income. That was the goal.

The only companies we understood were stock companies. We understood how corporations behaved. We understood how to identify, and tax their customers and their owners.

During the initial development of the 1984 act provisions, we focused on the stock companies. We put mutual companies aside. We applied normal tax policy analysis tools; we tried to determine how to measure the income of the stock companies rationally. I think we did a pretty good job. If I were grading us, I might give a B plus.

While we were focusing on the stock companies, we had little trouble. If stock companies paid anything to a purchaser of their insurance services, the amounts paid should be deductible. It's a business expense. If a stock company paid any amount to customers in their capacity as creditors, as a bank credits interest to its depositors, that should be deductible too. We didn't have any problem with these expenditures.

We also recognized that when a stock company pays anything to the owners of its stock, that distribution should be taxed like we treat distributions to owners of other corporations. Those amounts are not deductible. In addition, distributions made to a corporation's owners should be included in the owner's income. Dividends are taxable under our income tax system.

As is apparent, figuring out how to tax stock life insurance companies wasn't difficult. Although there were complexities of a technical nature, we weren't concerned that we were being harebrained or crazy.

Then we turned to the problem of taxing mutual companies. A number of people today will discuss whether mutual companies are overtaxed or undertaxed on their economic income. I can't answer that. Nor can anybody else. There is a fundamental problem with taxing mutual companies. This problem arises from the fact that mutual companies have customers who, in a legal sense, own the mutual companies. When an amount is paid or credited to the policyholders, you have to ask in what capacity are they being paid or credited. Are they being paid as customers? If so, the payments should be deductible, just like a stock company deducts payments to customers. If an amount is paid as interest to a creditor, again it should be deductible by the company. That's easy.

But if any amount is paid to that very same policyholder in the capacity as an owner of the enterprise, it shouldn't be deductible.

As an aside, the same type of question arises when you tax normal business corporations. The problem is how do you distinguish a company's debt from a company's equity. In 1969, Congress acted by telling Treasury to issue regulations that would distinguish debt from equity. Fortunately, a decade or so passed before Treasury issued any regulations. Finally, they came up with several sets of regulations. Ultimately, they abandoned the project because, no matter what they did, it was clearly wrong.

The hardest question in distinguishing debt from equity is what to do with hybred instruments that contain both debt and equity elements. That is the problem we've got here. When you talk about the economic income of a mutual company, you can't know what that income is without answering this question, which is one of the most difficult problems in tax law.

It's a simple empirical question, but there was no answer to it. I don't think that anybody can distinguish debt payments from equity payments of a mutual company. As a result, nobody knows how to compute the economic income of a mutual company.

In the process that you're engaged in, Mr. Chairman, I urge you to preserve the provisions that tax stock companies on their economic incomes. I think that this is the correct goal. The next step is to figure out how to adjust the provisions to tax the mutual companies in a sensible manner.

I could tell you what we did in 1983 and 1984. We initially made what we thought were reasonable assumptions. But when we started to draft statutory language, we produced the provisions that people are criticizing today. And, you know, it's an easy subject to make fun of. We first recognized that there the two types of companies each control about half of the life insurance business. They're in competition with each other. We then assumed that, as groups, they have the same rate of profitability. That seemed to be a reasonable economic assumption. The reason that we had to make this assumption was that we could not determine economic income of the mutual companies directly.

We took this reasonable assumption and tried to transform it into a statute. We asked what is the correct comparison? Could we use some other rate of return? Well, if a stock company and a mutual company earned the same return on their equity, what is a reasonable rate of return for a mutual company? Is it a 6-percent return on a tax-free bond or a 20-percent return that a stock company makes?

Well, we thought that the stock companies were more comparable. In addition, to the extent you screw up in defining equity for a mutual company, which is an important part of the fraction that defines the rate of return, your errors are likely to be the same for stock companies. These were the reasons for saying that stock and mutual companies should earn, on average, the same rate of return.

Is it a good idea to base one company's tax on another company's performance? No. But you have to make guesses as to what the mutual company's income is. And that's what they were, guesses.

Having decided that the mutual group of companies and the stock group of companies should have the same rate of return, we had to translate that concept into the computation of a mutual company's taxable income? We finally decided that each mutual company would be deemed to earn an additional amount of income based on the difference between the stock company's average rate and the mutual company's average rate. Why did we do this? This was proposed by the mutual companies. I'll admit that we weren't satisfied with this.

And I'll tell you that I'm not proud of this approach. I thought it was a little bit looney tunes when it was proposed.

Section 809 tries to treat mutual companies fair vis-a-vis the stocks. They are in competition with each other. If you undertax one, you're giving a competitive advantage to that group of companies. If you overtax one, you're hurting them. There's a tension there. But a simple solution is not necessarily the best answer. Of course, a complicated solution is not necessarily the best either. You are always going to have to struggle to figure out what is the economic income of a mutual company. It's not observable. There is no simple data you can look at. And based on the experience over the last 30 years, you are going to come up with a provision that's not going to make perfect sense. But you're trying to do something that is designed to achieve fairness.

The lesson that I've been trying to bring to you today, and it's not a happy lesson, is that this is a very, very difficult question. It's difficult not just because mutual companies are big businesses. They make profits, and you have to figure out what those profits are. That process is a very difficult one fraught with potential for mistaken assumptions.

I apologize for not having come up with the solution. I was part of a big team that failed to come up with the solution. And I am looking with interest in the hope that something simpler and better can come out. I am skeptical and I am not envious of your task, having to grapple with this issue.

That concludes my comments. I'll be happy to answer any questions.

[The statement of Mr. Pike follows:]

STATEMENT OF ANDREW D. PIKE
PROFESSOR OF LAW
WASHINGTON COLLEGE OF LAW, THE AMERICAN UNIVERSITY
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS OF THE
HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to discuss the taxation of the life insurance industry. I am appearing today in my capacity as a participant in the formulation of the statutory provisions under consideration. I do not represent any private interest.

The topic of today's hearings is the taxes paid by the life insurance industry. In addition to the level of industry taxes, one focus of today's hearing is the relative portions of industry tax revenues paid by the stock and mutual segments. Of major concern is the operation of section 809. This section can best be understood by examining its historic development. At the outset, the drafters of section 809 had as their primary goal to "level the playing field." For purposes of life insurance company taxation, this means creating a tax system that does not create a competitive advantage for either stock or mutual insurers.

Difficult problems were encountered in the pursuit of this laudable goal. First, it was necessary to discover the contours of the playing field. Second, the act of leveling the field proved quite troublesome. My testimony today attempts to highlight both the difficulties encountered in this process, as well as the tax policy decisions made to deal with these problems.

The Origins of Section 809

The Deficit Reduction Act of 1984 overhauled the tax provisions applicable to life insurance companies. In formulating these revisions, an attempt was made to have a life insurance company's taxable income approximate its economic profit. This framework for reform worked quite well when applied to stock life insurance companies. However, a serious concern was that the relative tax burdens of the stock and mutual segments of the industry might place either segment at a competitive disadvantage vis-a-vis the other. The possibility of a tax-induced competitive imbalance can be illustrated by comparing the operation and taxation of two hypothetical life insurance companies, one organized as a stock life insurance company and one as a mutual.

The stock life insurance company is relatively easy to analyze. It is an ordinary corporation operating in the insurance business that is owned by its stockholders. Its primary business is the sale of insurance products, such as cash value life insurance. These products consist of both a savings fund and term-like insurance protection. In its relation with its policyholders, the stock life insurance company operates both as a financial intermediary and a seller of insurance services.[1] Stock life insurance companies also invest their own capital.

The analysis of the hypothetical stock life insurance company

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[1] Each policyholder transfers cash to the insurance company in the form of premiums. A substantial portion of the amounts so transferred is then credited to the contracts' cash values. In a manner similar to other financial intermediaries, the life insurance company invests the policyholders' funds in financial instruments, such as bonds or mortgages. The process of financial intermediation is completed when the life insurance company credits interest to the cash values.

("STOCKCO") in Table 1 illustrates these business activities.[2] In its capacity as financial intermediary, STOCKCO in effect borrows $10,000 from each policyholder for which it pays interest at a 9% rate. Its investment of these funds produces a 10% rate of return. STOCKCO's gross profit as a financial intermediary consists of the 1% difference between its cost of funds and its investment yield. Similarly, STOCKCO sells insurance services, which is a form of risk-shifting. In this capacity, it collects fees (the $350 mortality charges) from many customers, and pays death benefits ($100,000) to the beneficiaries of the few insured individuals that die during the period of coverage. STOCKCO's gross profit as a seller of insurance services is the excess of the aggregate mortality charges collected ($350,000) over the total death benefits paid ($200,000). The operating expenses must be allocated to determine the net profit from each activity.

Using principles generally applicable to non-insurance corporations, the taxation of stock life insurance companies is relatively straightforward. Amounts that STOCKCO credits to policyholders in their capacity as creditors should be deductible as interest. In addition, death benefits paid and operating expenses incurred should be deductible as ordinary and necessary business expenses. Its taxable income equals its profit of $250,000.

Equally important is the tax treatment of STOCKCO's dividend distributions. First, STOCKCO cannot deduct the $100,000 paid to its stockowners as dividends. Consequently, STOCKCO's taxable income includes both its retained earnings as well as the amount distributed to its stockowners. Second, the dividends paid are included in the stockowners' gross income.

Once the 1984 Act's structure for taxing stock life insurance companies was in place, it was necessary to decide if any adjustments were needed to deal with mutual companies. The most significant difference between stock and mutual companies is that a mutual life insurance company is not owned by a separate class of stockowners. The owners of a mutual company are its policyholders. Otherwise, the mutual company is quite similar to a stock company: it also sells insurance products that contain both savings and insurance features. In addition, a mutual life insurance company operates with respect to its policyholders both as a financial intermediary and a seller of insurance services.

The Contours of the Problem

Table 2 illustrates the mutual company "problem." MUTUALCO, our hypothetical mutual company, sells the same number of life insurance contracts as STOCKCO, for which it charges the same premium.[3] In addition, MUTUALCO earns the same rate of return on its invested assets. The only observable difference is that the December 31, 1988 cash value for the MUTUALCO life insurance contracts are larger: $10,700 rather than $10,550. In effect it credited $150,000 more to its policyholders than did STOCKCO.

To discover the contours of the tax playing field, it was, and remains, necessary to decide how to characterize these additional amounts credited to the cash values. The following characterizations are possible:

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[2] This analysis simplifies many elements of insurance company accounting to highlight the differences between stock and mutual companies. For example, it ignores the difficulties inherent in accounting for insurance contracts of long duration, and it considers only a homogeneous group of cash value life insurance contracts.

[3] Although it is assumed that MUTUALCO charges the same premium as STOCKCO, the analysis presented herein would not be materially altered if: (1) MUTUALCO charges higher premiums and (2) the additional premiums do not cause MUTUALCO's taxable income to increase. To the extent that the excess premium charged by MUTUALCO increased its taxable income, the return of that excess to the policyholder should be deductible.

- a reduction in the mortality charges imposed for the term-like insurance protection that the mutual company provided in its capacity as seller of insurance services;
- an increase in the amount that the mutual company credits as interest in its capacity as financial intermediary; or
- a distribution of the mutual company's corporate profits to its owners.

In concept, the application of principles generally applicable to non-insurance corporations to these additional distributions is not difficult. Deductions are appropriate to the extent that the additional amounts constitute either rebates of mortality charges or additional interest credits. No deduction is warranted, however, to the extent that the additional amounts represent a dividend-like distribution paid to the mutual company's owners.[4] Moreover, dividend-like distributions are properly included in the policyholder's gross income.

The proper tax treatment of mutual companies thus requires resolution of one empirical question: how should mutual company distributions be allocated? Unfortunately, no satisfactory empirical answer to this question was presented. The lack of satisfactory empirical evidence may be traced to two problems. First, differences in amounts credited may reflect different contractual terms in contracts issued by mutual and stock companies.[5] Second, and more significantly, any observed difference between amounts credited by stock and mutual companies is consistent with several different interpretations.

Unless the Tax Code allocates mutual company distributions correctly, either the stocks or the mutuals would be advantaged. In the absence of satisfactory empirical evidence, a critical assumption was made in 1984. It was assumed that mutual companies, as a group, would have the same rate of return on their equity as stock companies. This assumption had intuitive economic appeal: absent evidence to the contrary, one would expect groups of companies competing in the same industry to have approximately the same level of profitability.

From this pivotal assumption flowed all of the particulars of section 809. At an intuitive level, the meaning of the terms "equity" and "rate of return" were widely understood. However, when it came time to translate these terms into statutory language, it became apparent that several difficult problems needed resolution. The principle that was simple in concept became the complex provision that is central to this hearing.

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[4] According to Professor Michael Graetz, dividend-like distributions of a mutual company are properly deductible to the extent that the mutual company was taxed on the amounts contributed to its capital. Professor Graetz also observed that no deduction is appropriate, however, to the extent that the capital contributions did not increase the mutual company's taxable income. See Graetz, "Life Insurance Company Taxation: An Overview of the Mutual-Stock Differential" in Life Insurance Company Taxation -- The Mutual vs. Stock Differential (1986) As an empirical matter, it is questionable whether a significant portion of the January 1, 1984 equity of mutual companies is attributable to taxable capital contributions.

[5] Under participating contracts traditionally issued predominantly by mutual companies, premiums were based on the assumption that interest would be credited at relatively modest rates, and that mortality charges would be relatively high. Because the insurance company's risk exposure is reduced, additional amounts are credited if investment returns exceed the assumed levels, or if the policyholders' experienced mortality are better than anticipated. In comparison, the rate of interest credited and the mortality charges imposed were fixed under nonparticipating contracts traditionally issued predominantly by stock companies.

The Troublesome Task of Leveling the Playing Field

In devising the statutory provision, the first step was to determine the expected rate of profitability. After considering such alternatives as the average rate of return earned by large publicly-held corporations, it was decided to proceed on the premise that mutual companies, as a group, would earn a rate of return on their equity comparable to that earned by stock companies. This decision had two virtues. First, the average rate of return realized by mutual companies is more likely to track the profitability of other insurance companies than the return of industrial companies. Second, any flaws in the definition of equity should have minimal effect to the extent that both stock and mutual company equity are miscalculated. Unfortunately, selection of the stock company rate also had the effect of basing the tax liability of mutual companies on the performance of stock companies.

The next step was to decide how differences between the average stock company rate of return and that of the mutual companies should be reflected in taxable income. In concept, the extent to which the mutual companies' reported earnings were less than "expected" represents amounts distributed to policyholders in their capacity as owners of the mutual enterprises. Although mutual life insurance companies otherwise would be allowed to deduct all amounts credited to policyholders,[6] no deduction should be allowed for the dividend-like distributions. A further disallowance at the corporate level is justified in lieu of having the policyholders include these amounts in income.

Finally it was necessary to decide how each mutual company would be affected. Two alternatives were considered. Under the first approach, each mutual company would be treated as if it earned a return on its equity at a rate equal to the average stock company rate. Critics legitimately argued that this approach gave no recognition to differences in profitability of different mutual companies.

An alternative proposed by the mutual companies was ultimately enacted. Under this alternative, the average rate of return for both stock and mutual companies is computed. Each mutual company is then deemed to have paid dividend-like distributions in an amount equal to the product of: (1) the excess of the stock earnings rate over the mutual rate; multiplied by (2) the company's own equity.[7] It was recognized that this approach had certain bizarre consequences. Most significantly, when one mutual company incurs an expense, it reduces its own earnings rate and, indirectly, the average mutual earnings rate. This causes the amount of disallowed deductions to increase for all mutual companies. In effect, a mutual company's tax liability depends on the behavior of its mutual brethren s well as the economic performance of its stock company competitors.

Conclusion

The history of section 809 shows how a simple, and intuitively reasonable, procedure for taxing mutual life insurance companies may raise difficult problems when it undergoes the scrutiny involved in producing statutory language. This complexity may follow inexorably from the decision to tax stock life insurance companies in a rational manner. Once that decision is made, some mechanism is needed to prevent mutual companies from enjoying a competitive advantage under the tax laws. The implementation of such a mechanism is likely to encounter the same fundamental difficulty as was encountered in the development of section 809: how to distinguish equity-like returns of a mutual company from other types of distributions.

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[6] Technically, the deduction would be allowed either as an increase in the company's reserves (IRC § 807) or as a policyholder dividend (IRC § 805(a)(3)).

[7] The amount of corporate deductions disallowed is increased further in lieu of imposing a policyholder-level tax on the dividend-like distributions received.

TABLE 1: COMPUTATION OF STOCKCO INCOME

For purposes of this illustration, the following simplifying assumptions are made:

(1) Each insurance company has equity of $1 million.

(2) On January 1, 1988, 1,000 individuals purchase STOCKCO life insurance contracts with the following terms:

The premium for each contract is $10,000.

If the insured dies during 1988, the policy beneficiaries receive $100,000 plus the contract's cash value on the date of the insured's death. STOCKCO charges each policyholder $350 to assume this obligation.

In computing the cash value of each life insurance contract, STOCKCO credits interest at a 9% rate. On December 31, 1988, the cash value is computed as follows:

premium paid	$10,000
+ interest credited at 9%	900
- mortality charge	(350)
CASH VALUE	10,550

(3) During 1988, STOCKCO's assets consist of its $1 million of equity and $10 million of premiums. It is assumed that these assets are invested and earn a 10% rate of return, or $1.1 million.

(4) On December 31, 1988, two individuals insured by STOCKCO die.

(5) STOCKCO's ordinary operating expenses are $50,000.

For 1988, STOCKCO's profit, and its taxable income is computed as follows:

Gross Income		
Premium Income	$10,000,000	
Investment Income	1,100,000	
Gross Income		11,100,000
Deductions		
Increase in Reserve Liabilities[8]	10,550,000	
Death Benefits	200,000	
Operating Expenses	50,000	
Total Deductions		10,800,000
Taxable Income (Profit)		300,000
Tax		100,000
Dividends Paid to Stockowners		100,000
Retained Earnings		100,000

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[8] STOCKCO may deduct the increase in its reserve liabilities for the year. IRC § 807(b). For purposes of this example, it is assumed that STOCKCO's reserves as of January 1, 1988 are zero, and that its reserves as of December 31, 1988 equal the aggregate cash value of its life insurance contracts on that date. Because the cash values of these contracts are increased to reflect the interest credited, STOCKCO is effectively allowed to deduct these amounts. Similarly, STOCKCO effectively includes the mortality charges in its income because the cash values are reduced to reflect those charges.

TABLE 2: COMPUTATION OF MUTUALCO INCOME

This illustration uses the same assumptions as Table 1 except that each life insurance contract's cash value on December 31, 1988, will equal $10,700 rather than $10,550. IF MUTUALCO's taxable income were computed in the same manner as STOCKCO's, its taxable income would be computed as follows:

Gross Income		
Premium Income	$10,000,000	
Investment Income	1,100,000	
Gross Income		11,100,000
Deductions		
Increase in Reserve Liabilities	10,700,000	
Death Benefits	200,000	
Operating Expenses	50,000	
Total Deductions		10,950,000
Taxable Income (Profit)		150,000
Tax		50,000
Retained Earnings		100,000

Chairman RANGEL. Thank you, professor.

I think the record should be made clear that your contribution as an architect of the legislative provisions we're considering now was not as a member of Washington College of Law, but as part of the Treasury Department when you served well with them. And it is refreshing to see that you have not been retained by any part of the industry. [Laughter.]

Mr. PIKE. I have sought to retain my status as the lowest paid expert on life insurance tax matters. [Laughter.]

Chairman RANGEL. Well, judging from what you've said is that, after hearing the testimony of Treasury and the General Office of Accounting, you still think that, given the complexity of the situation, you came up with the best available answer?

Mr. PIKE. As long as you emphasize "available," yes. I don't know if you recall years ago when the New Orleans Saints were a very bad football team. People showed up for their games with brown paper bags with their eyes cut out. I wanted to appear in that manner today. [Laughter.]

I'm not confident that it's the best result. It was the best that we could do. And I am not confident that anything else is going to be better. I've looked at alternatives. We spent a lot of time considering alternatives. And I'll tell you, they all had problems and the potential to really screwing things up. We may have screwed things up too. But I don't think that the alternative approaches are necessarily as simple or as elegant or as fair as they may sound.

They all have the potential to be complex. I can assure you that when you get down to the nitty gritty, any provision you're going to come up with is going to be complex.

Chairman RANGEL. Do you know Professor Michael Graetz at Yale?

Mr. PIKE. Yes, I do.

Chairman RANGEL. Have you had an opportunity to read or understand some of his positions on this?

Mr. PIKE. I've read them and I think that I understand them.

Chairman RANGEL. I assume you disagree with his conclusions?

Mr. PIKE. I would be very wary of any advice given to you from a law professor with a beard. [Laughter.]

Professor Graetz's paper, which was prepared several years ago, is a very, very well done paper. I have read it carefully. When advocates for the mutual companies discuss "Graetz's theory," I urge you to do the same and read the entire paper with care. I think that he is dead right, given the assumptions he makes.

He assumes, and this is a crucial assumption, that if premiums are fully taxed to the mutual company, particularly those portions of premiums that represent the mutual company's equity, then they should be allowed a full deduction for the dividends they pay to their policyholders in their capacity as owners of the enterprise. I think that's right.

Mike has two caveats that I believe are crucial. There may be others that I haven't really focused on. First, I have serious questions as to whether the existing amount of equity that a mutual company has, was taxed when it came into the company. Most of the equity came in under the provisions of the 1959 act or maybe earlier. I do not believe, given the reserve rules that were in effect at that time, that those amounts were fully taxed to the company. Professor Graetz's paper recognizes that that may be possible. That's why I suggest that you look at the paper carefully because the analysis was fair and well done.

The second problem is that a mutual company shareholder is not taxed when the shareholder receives any dividend like amount in that person's capacity as owner of the enterprise.

This was understood by the staffs and I know it was understood by the senior Treasury tax policy officials. It was also understood that section 809 would reflect the failure to tax those amounts at the owner level by overtaxing the company in lieu of taxing both parties correctly.

Taxing the wrong person on a transaction to compensate for undertaxing another person is something that the Tax Code does with some frequency.

Given those two caveats, I think that Mike's paper is correct. But those two assumptions are central.

Chairman RANGEL. Thank you, professor.

Mr. Coyne.

Mr. COYNE. No questions.

Chairman RANGEL. Mr. Stark.

Mr. STARK. I agree with you. All I can recall is that your history is correct. We started with the stock companies, in a sense saying these are corporations and we know to tax them, or we could figure out what their income is. We know we're going to have to find a place to make adjustments or estimates to do the comparable—provide comparable treatment to mutual companies.

Some of the mutual companies had asked if I would be willing to do away with 809? And I said I would but only to replace it with what?

But I did want to ask this. I understand that we are going to hear some testimony on one issue, be quits with 809. But are there not basically two theories on where the capital came from, and leave the evolution to the genesis theory and the theory? Have you ever heard of the entity theory?

Mr. PIKE. I've heard of genesis but I'm not sure in connection with insurance companies.

Mr. STARK. Let's look at it this way. If you take Professor Graetz's theory that there shouldn't be any tax on current income because current policyholders own the enterprise, then if you liquidate a mutual company who should get the reserves?

Mr. PIKE. I've always wanted to be the last policyholder of a mutual company, particularly a big one. But I don't think that fairly reflects Professor Graetz's statement.

Mr. STARK. I don't either. And as a matter of fact, I suspect there was a period developed for a different purpose that says how should we distribute the value of resources of this company, who should get it? And I think you will find the long scholarly faces on the other side of the issue, saying huh uh, it all, that capital was donated by great grandpa because when he croaked, he left that extra reserves to the company for future generations.

And I just wonder if you are familiar with the two theories. They both could be right, I assume.

Mr. **Pike**. Professor Graetz is here and I'm sure he'll be happy to speak at length about this. As I understand it, as Professor Graetz analyzes the world, if the capital that is currently there was taxed to the mutual company, that is it increases its tax liability, then all the income that flows from that capital should be deductible by the company when distributed to its policyholders because the stock company was not taxed on the capital contribution. I believe that analysis is correct.

The factual question that needs to be addressed, and Professor Graetz, in all fairness, stated this very clearly in his analysis, is where did today's capital come from? And even if it came from grandpa, it may be appropriate to not tax today's folks if that capital was taxed in full. To determine whether grandpa's capital contribution was taxed in full requires an analysis of the company's performance in the last 50 years.

Did those premiums, which constitute the company's equity when reinvested, increase the mutual company's taxes? It doesn't matter whether it came from today's policyholders.

My sense of the performance and the effect of the 1959 Act provisions was that a significant portion probably was not taxed, but I want to emphasize "probably."

I have not looked at the data. That is my gut feeling.

You will hear, I have no doubt, extensive analysis from actuaries as to whether it was or not.

It is important to determine the portion of the capital contributions from the current policyholders

Mr. **Stark**. Would it hold, then, would it be good tax policy, in liquidation, to have the same theory followed through? If you were going to liquidate a company, would you make the decision, does the entity own that, or do the policyholders own it?

Is there any reason——

Mr. **Pike**. I think they're very closely related but not identical questions. And the analysis should be similar, but not quite identical. There are differences, and you have to take those differences in account.

Mr. **Stark**. Would you suggest that whichever theory, the enterprise theory or the current owner theory, we should still use section 809?

Mr. **Pike**. I suspect you will need an 809 or an 809 substitute. I would not defend every particular of 809.

I've got to tell you, some of it is real bizarre. But I'll tell you something else, the predecessor of 809 is real bizarre too. And you know something? I've got a hunch the successor to 809 is going to be pretty bizarre as well.

Chairman **Rangel**. I'm glad you cleared that up.

Mr. Downey.

Mr. **Downey**. Thank you, Mr. Chairman.

Professor Pike, I'm only sorry that when I was at American University Law School, you were not there.

Mr. **Pike**. I'm sorry as well. But I assure you, I would not have taught you life insurance company taxation.

Mr. **Downey**. I think I got a C in it anyway. So I'm intrigued by, in layman's terms, the fact that you decided to look at stock companies because you could basically figure them out, and you could figure out basically what their economic income was, and you couldn't do that for mutual companies, and therefore, in an attempt to make sure that both of them paid taxes, you applied some of the lessons learned with the stock companies against the mutual companies, and tried to deal with it, and that was the product of your work.

And I think you've just given me a very lucid explanation, one of the better ones that I have listened to, about how this happened to be.

But maybe it's because I'm not an expert on this, and I don't certainly presume to be, I think that we've got to be able to do better. But let me ask you a question about the notion of the continued differential that exists between stocks and mutual life companies.

Wouldn't it follow that if you were going to maintain this differential, that you provide a differential between mutual life companies and stock life companies?

I mean, what effect does it have in terms of your analysis that stock companies have certain abilities offsetting against other losses that mutuals do not?

Is that fair? Is that reasonable? Is that just a course of business that we should be prepared to accept? Or is it something that we should consider as a factor when we look at their respective tax liability?

Mr. **Pike**. I think you're referring to the ability of a stock company to offset losses against a parent company, engaged perhaps in the property casualty business.

I think that's a factor. To the extent that stock companies are able to shelter their income through shifting their capital or their resources to another portion of a larger consolidated enterprise, that should be reflected.

One thing we were hoping to do was to try to fix up the taxation of property casualty insurance companies. Those rules really work very poorly, at least from the government's perspective.

There were studies done that showed that the effective tax rate for property casualty companies was negative.

Some progress was made in the 1986 act on that count. But to the extent that losses are created from artificial accounting techniques, such as occurred in the property casualty business, or from other tax shelter activities that are available to the stock companies but not the mutuals, I think they should be reflected in the balance, if you want to approach the problem that way.

However, to the extent that affiliates have real economic losses, the Tax Code has looked at the tax liability of the entire enterprise. Losses from one business offset the income from another business in determining the tax liability of the entire enterprise.

I think that's a good principle, and I think it's one that has been in the Tax Code for generations. To the extent that a benefit through consolidation is available disproportionately to one segment or another, it probably should be reflected or taken into account in your analysis.

Mr. **Downey**. Thank you.

Chairman **Rangel**. Thank you. We're joined by Ms. Kennelly, who has no small interest in this subject matter. And her full statement will be in the record.

As you indicated you were with the Intelligence Committee, and that has been explained.

If you have any questions, I yield.

Mrs. KENNELLY. Thank you. And I do apologize for being late. But since I feel this really is an interim hearing, and that we'll be hearing further from Treasury with much more updated material, I know that I can read the testimony and get right up to speed.

However, Mr. Chairman, I do want to thank you for holding this hearing. Because we, who were involved in this legislation, all know that it's incredible, it's arcane, it's complicated, but it's very important. So I thank you for holding this hearing. And I look forward to the next hearing before we decide if we will act on this very important subject.

Chairman RANGEL. Mr. Vander Jagt.

Mr. VANDER JAGT. No questions.

Chairman RANGEL. Well, Professor, we'll just have to staple you to the bill, and have you explain it as well as you have done in the past.

And we want to thank you for sticking with us, notwithstanding the fact that you're at the university. The respect that you enjoy from people who differ with the conclusions that were reached says a lot about the contribution that you made.

And I hope you stick with us. Thank you very much.

Mr. PIKE. Thank you very much, sir.

Chairman RANGEL. We have a panel. The Stock Company Information Group: William Harman, Jr., legal counsel, SCIG, and partner, Davis & Harman, Washington; the Mutual Company Life Insurance Tax Committee: Donald Schuenke, president and chief executive officer of Northwestern Mutual Life Insurance Company, Milwaukee; and he'll have Theodore Groom, counsel, Mutual Legislative Committee, of Groom & Nordberg, Washington.

Now, Mr. Schuenke, you brought your own camera people with you, didn't you? You okay where you are? Very good.

Mr. Harman's representing the Stock Company Information Group. Mr. Schuenke, the Mutual Company Life Insurance Tax Committee.

All right, now, we have your written testimony. And you've heard as to the committee, as with all of the witnesses, by unanimous consent, the full and complete text of your statement will be entered into the record.

And then if you could highlight that testimony, we would appreciate it.

Let us start off with Mr. Harman.

STATEMENT OF WILLIAM B. HARMAN, JR., COUNSEL, STOCK COMPANY INFORMATION GROUP, AND PARTNER, DAVIS & HARMAN, WASHINGTON, DC

Mr. HARMAN. Thank you, Mr. Chairman. My name is William B. Harman, Jr. I am an attorney in Washington, D.C., with the law firm of Davis & Harman.

Today I am here in the capacity as the representative of the Stock Company Information Group.

The Stock Company Information Group, a group of 26 investor-owned life insurance companies, is very pleased to have the opportunity today, Mr. Chairman, to testify.

The hearing notice indicated that the purpose of the hearing was to focus on the amount of income taxes paid by the life insurance industry during the years 1984 and 1985, and also to focus on the amounts paid by the two segments, the mutual life segment and the stock life segment.

In this regard, my testimony will address the interim report of the Treasury Department, which is where the basic revenue numbers are presented.

Before I get into the numbers, let me state the basic position of the Stock Company Information Group. That position is and has been, Mr. Chairman, the desire to have each life insurance company, whether stock or mutual, large or small, taxed on its economic income, neither more nor less.

The reason we believe that is the right way to do it is that in a very competitive life insurance industry there should not be any discrimination or favoritism under the tax system.

Federal income taxes are an important cost of doing business, and that cost should be levied fairly among all the life insurance companies.

Now with respect to the Treasury Department report, with two exceptions which I will mention later, the stock companies believe that the Treasury data is the best data base available. We believe the Treasury has done an outstanding job in gathering this data, and we believe it is the most reliable source that this committee could use.

After analyzing this data, we have reached the conclusion that the stock companies, based on the estimates made, have paid the taxes that the Congress thought the stock companies should pay in 1984.

We believe that the Treasury data shows that the mutual companies have fallen far short of the taxes the Congress believed they should pay in 1984.

You've heard Mr. Neubig go through the numbers. I will briefly summarize those numbers which are in my statement on page 4. They are also in the Treasury statement and in the Joint Committee print prepared for this hearing.

To summarize, for the 2-year period 1984–85, it was estimated that the stock companies would pay $2.8 billion in taxes. The actual numbers, according to the Treasury Department study, was $3 billion. So there was a slight payment in excess of the revenue estimates. I'll comment on that in a moment.

On the mutual company side, it was estimated for the 2-year period to be $3.3 billion. The actual number was $1.95 billion, so there was a shortfall of approximately $1.3 billion.

In effect, the estimates were off from the actual numbers by about 41 percent.

Now what conclusions do we draw from the 1984 act and these numbers?

We believe, contrary maybe to some of Mr. Pike's modesty, that the Congress succeeded in the 1984 act in developing a tax system or a tax structure that includes all of the income items of a life insurance company, stock and mutual, and that it provides for the proper deductions for a stock life insurance company.

In other words, we believe that a very sound tax structure was developed for the stock life insurance companies.

We believe that, in this regard, the 1984 act is working. With a proper structure, Mr. Chairman, then if the company has more income than it was estimated, which I think was true for the stock companies in 1984 and 1985, their taxes will be in excess of the estimate, and that is proper.

Because if the model, the structure, is correct, the economic income will show up; and the tax will be paid.

Now with respect to the mutual life insurance companies, we believe that the Congress got straight their income items and their deduction items with one major exception: section 809.

Section 809, as Professor Pike explained better than I could, was simply there to try to provide a tax at the corporate level on amounts that were distributed to the owners of the mutual life company.

It was there to also give a deduction for those amounts returned in the form of a customer return.

However, we do not believe that it worked out as was intended by the Congress. There was a considerable shortfall.

Now, why was this shortfall? What happened? The Treasury Department explained in their testimony and in their paper that there were errors in revenue estimating. We all know the difficulty of revenue estimating.

We on the stock side believe there were additional problems. We do not know on the stock side however, what these tax planning devices are. But based on the revenue that is being paid by the mutual side, there are some mistakes in 809 I believe that Mr. Schuenke and others in the mutual segment could explain better than we could, Mr. Chairman.

Now, the two exceptions that I say that the stock group takes with respect to the Treasury report. Both of these exceptions show up in your Joint Committee pamphlet, in the summary on page 3, where they point out there are several factors that the committee should take into account in reviewing the Treasury report.

I wish to comment on two of these factors. One of them states that the revenue estimates are shown on a consolidated basis, whereas the Treasury report states that it may be appropriate to examine the effect of the tax law on life subgroups before consolidation.

We believe that the correct way to determine whether a life insurance company, stock or mutual, is on the right economic tax structure, is to do it before consolidation.

And I say that with several simple examples. If there is a life insurance company you're trying to tax properly, and it happens to be affiliated with General Motors, which let's assume is profitable, would you attribute the profit of General Motors to that life insurance company?

I think the answer is no, because that's a different form of tax entity. It is not in the insurance business. You would not attribute the income of General Motors to that company.

Similarly, if you assume the life insurance company were affiliated with a corporation, perhaps a U.S. Steel which may be in a loss position, you would not reduce the income of that life insurance company by the loss of an affiliate.

The whole exercise in 1984, as well as in all prior years, was to try to determine the appropriate structure for taxing a life insurance company.

The question of consolidation is a general tax question applicable to all corporations, not just the insurance industry.

Now let me point out that if you look at the stock and mutual companies on a before-consolidation basis——

Chairman **RANGEL**. Excuse me, but would you try to summarize, Mr. Harman?

Mr. **HARMAN**. Yes, sir, I talk slowly, as you perhaps have heard.

If you look at it on a before-consolidation basis, you will see that stock companies paid about $3.9 billion; the mutual companies about $2.2 billion to a substantial discrepancy.

The second factor, Mr. Chairman, would be simply that, in looking at the stock life company. It's important to take into account both the company tax as well as the tax on the stockholder.

In summary, we believe the 1984 act is working for the stock side. We do not think it is working as intended for the mutuals. That gives us concern of tax competitive equality in the marketplace.

We think it should also give concern to the Treasury and to the Congress as to determining the proper revenue that should be derived from both the mutual side and the stock side.

I thank you, sir.

[The statement of Mr. Harman follows:]

September 27, 1988

STATEMENT OF WILLIAM B. HARMAN, JR.
ON BEHALF OF
THE STOCK COMPANY INFORMATION GROUP
IN CONNECTION WITH THE HEARING BEFORE
THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
CONCERNING
THE TAXATION OF LIFE INSURANCE COMPANIES

Mr. Chairman and members of the Subcommittee: My name is William B. Harman, Jr. I serve as counsel to a coalition of stock life insurance companies known as the Stock Company Information Group. I appear before you today on behalf of this group, to assist in your review of the provisions of the law governing the income taxation of life insurance companies as substantially revised by the Deficit Reduction Act of 1984 (the "1984 Act").

The Stock Company Information Group (the "SIG") consists of 26 investor-owned life insurance companies. It originally was formed in 1981 to monitor tax legislative developments, and to convey to the various life insurance trade associations and the Government the views of its membership on life insurance tax issues. Taking into account its members' affiliated companies, the SIG includes a majority of the 50 largest stock life insurance companies in the United States. The SIG has been privileged to work closely with this Subcommittee, the Committee on Ways and Means, and their staffs in connection with the development of the insurance tax provisions of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), the 1984 Act, the Tax Reform Act of 1986, and the Revenue Act of 1987. A list of SIG member companies appears at the end of this statement.

The focus of this hearing, according to the Subcommittee's notice, is the amount of income taxes paid by the life insurance industry, and the relative tax burden of mutual life insurance companies and stock life insurance companies, since the enactment of the 1984 Act. Specifically, the hearing notice encourages testimony on the Interim Report to the Congress on Life Insurance Company Taxation prepared by the Department of the Treasury, dated June 15, 1988 (the "Interim Report"), which addresses these issues.

The amount of Federal income taxes paid by life insurers, and particularly the amounts paid by the stock and mutual segments of the life insurance industry, are of special concern to the SIG. The fact is that, in selling their products, stock companies are in competition with each other and with mutual life insurers. As an element of a company's operating cost, this tax burden can have a significant effect on product price, and the distribution of this burden among companies ultimately looms large in determining the competitive balance within the industry. Stated in other words, if some companies are taxed heavily while others substantially escape any tax burden, those who are not taxed will enjoy an unfair advantage in the marketplace, to the detriment of those who bear the tax burden. The SIG desires to have each life insurance company, whether stock or mutual, taxed on its economic income (neither more nor less) so that there exists no tax-induced competitive advantage or disadvantage within the insurance marketplace.

In view of this concern, the SIG member companies are dismayed at the findings of the Interim Report (which are summarized in Part I of this statement). True, those findings show that stock life insurers are paying Federal income taxes at or above the level that Congress expected them to pay under the 1984 Act. Accordingly, as discussed in Part II of this statement, no change is necessary in the way that stock life insurers are taxed under the 1984 Act.

On the other hand, the findings of the Interim Report show that mutual life insurers are not paying Federal income taxes at the expected level. For the 1984-1985 biennium, the tax payments of the mutual segment have fallen short of congressional expectation *by more than $1 billion*. Thus, as discussed in Part III below, the provision of the law enacted in 1984 specifically designed to preclude this result -- section 809 of the Internal Revenue Code -- is not working as intended by Congress and warrants careful reexamination and restructuring.

I. The 1984 Act and the Interim Report

After much study, and extensive hearings by this Subcommittee, Congress, in the 1984 Act, comprehensively revised the way that life insurance companies are taxed. A cornerstone of the new taxing scheme enacted by the 1984 Act was the determination that "life insurance was primarily a commercial activity, and that no company should engage in it without being subject to Federal corporate income taxes." H. Rep. No. 98-432, Pt. 2, 98th Cong., 2d Sess. 1398 (1984). Therefore, following the lead of this Subcommittee, Congress undertook to revise the rules of the law so that stock life insurers would be taxed on their full economic income. At the same time, Congress concluded that all life insurance companies should be taxable based on a "stock life insurance company model," id. Section 809 of the Code was enacted to effectuate this basic policy decision in the case of mutual life insurers.

Although it is complex in operation, section 809 serves a very simple purpose: identifying that portion of the policyholder dividends of a mutual life insurer that represent nondeductible distributions of corporate earnings. Since the policyholders of a mutual life insurer are both its customers and its owners, Congress recognized that, to some extent, policyholder dividends of a mutual life insurer are distributions to them in their ownership capacity. The Federal corporate income tax does not allow stock life insurers (or any other investor-owned corporation) to deduct such distributions, and so the objective was to deny mutual life insurers a deduction when they made similar distributions. Disallowance of this deduction was not, and is not, purely a theoretical exercise; it was, and is, necessary to preserve the lion's share of corporate earnings in the Federal income tax base, including the tax base of mutual companies.

The problem Congress faced, however, was that the "ownership" and "customer" portions of the policyholder dividends of a mutual life insurer are not readily discernible. Mutual companies do not distinguish between the two. Accordingly, Congress needed to construct some mechanism to identify the nondeductible ownership portion, and the mechanism decided upon in the 1984 enactment is embodied in section 809. This is not to say that 1984 was the first time that Congress had faced this problem, for no tax law ever enacted by Congress disregarded this problem and permitted a full deduction for mutual policyholder dividends. In 1984, however, section 809 was a new and untried mechanism for resolving the problem.

Thus, two issues were of particular concern to Congress during the final stages of its 1984 reformulation of the life insurance company tax rules, and section 809 in particular: (1) the amount of Federal corporate income taxes paid by the life insurance industry as a whole, and (2) the relative income tax burden borne by mutual and stock life insurers. The second of these concerns, sometimes referred to as "segment balance," focuses directly on the effectiveness of section 809 in taxing mutual life insurers on their economic income by denying deductions for the ownership returns in policyholder dividends.1/ Accordingly, Congress "decided that it would be necessary to maintain close scrutiny of these two matters," id. at 1460, and it enacted section 231 of the 1984 Act requiring the Treasury Department to submit reports to Congress on these issues.

In June of this year, the Treasury submitted its Interim Report in response to the Congressional mandate in section 231. The purpose of the report "is to evaluate the revenue effect of the life insurance company tax changes of [TEFRA] and the 1984 Act and to provide data on taxes paid by the life insurance industry and segment balance." Interim Report at 1. The analysis of the revenue effect of the 1984 Act was based on data reported to the Treasury Department in a special survey of life insurance companies conducted in 1987. The principal finding of the Interim Report was that "the tax payments of the life insurance industry and the relative shares paid by the mutual and stock segments in 1984 and 1985 did not meet Congressional expectations." Interim Report at 2.

In brief, Congress expected that for 1984, the tax revenue from the life industry as a whole would be **$3.0 billion**, of which **$1.6 billion** would be paid by the mutual segment and **$1.4 billion** would be paid by the stock segment. In fact, the Interim Report finds that the life insurance industry as a whole paid only **$2.4 billion**, **$1.0 billion** of which was paid by the mutual segment and **$1.4 billion** of which was paid by the stock segment. 2/ For 1985, Congress expected that the tax revenue from the industry as a whole would be **$3.1 billion**, of which approximately **$1.7 billion** would be paid by the mutual segment and **$1.4 billion** by the stock segment. Again the industry as a whole was found to fall short, paying **$2.9 billion** of which **$1.3 billion** was contributed by the mutual segment and **$1.6 billion** by the stock segment. 3/ The chart below summarizes and contrasts the expected revenue and the actual revenue for the years 1984 and 1985 according to the Interim Report:

1/ Segment balance is sometimes portrayed as an arbitrary allocation of tax between the stock and mutual segments of the industry to reach preconceived results, and even to offer competitive protection to one segment against the other. The SIG does not believe this properly describes Congress's use of segment balance in 1984 (or in prior enactments), and in any event the SIG opposes any such arbitrary, preconceived tax allocation. The goal of section 809 (or of any successor provision), whether or not identified with segment balance, must be to levy tax on the economic income of the mutual life insurance organizations.

2/ The $1.0 billion figure for the mutual segment represents the tax liability reported on returns for 1984 and does not reflect the so-called section 809(f) "true-up" amount attributable to 1984, but reported on returns for 1985. Taking into account this true-up, the Interim Report finds that the taxes paid by the mutual segment attributable to 1984 was $1.35 billion.

3/ The $1.3 billion figure for the mutual segment again does not reflect the section 809 true-up. Taking into account the true-up, the Interim Report finds that the taxes paid by the mutual segment attributable to 1985 was only $0.6 billion.

Life Insurance Industry
Federal Income Tax Liabilities:
After Life-Nonlife Consolidation

	Segment	Estimated	Actual	Payments Over (Under)
1984	Stock Cos.	1.4	1.4	-----
	Mutual Cos. w/o true-up	1.6	1.0	(0.6)
	Mutual Cos. w/true-up	1.6	1.35	(0.25)
1985	Stock Cos.	1.4	1.6	0.2
	Mutual Cos. w/o true-up	1.7	1.3	(0.4)
	Mutual Cos. w/true-up	1.7	0.6	(1.1)
Both yrs.	Stock Cos.	2.8	3.0	0.2
	Mutual Cos. w/o true-up	3.3	2.3	(1.0)
	Mutual Cos. w/true-up	3.3	1.95	(1.35)

This summary of expected and actual payments is also illustrated in two graphs that are printed in this statement. To provide some sense of pre-1984 Act history, the graphs show tax payments for a number of pre-1984 years as well.

With one basic exception, noted in Part II below, the SIG fully accepts the methodology and findings of the Interim Report. Indeed, the findings come as no surprise. In letters on behalf of the SIG to then Assistant Secretary of the Treasury Ronald Pearlman, dated September 25, 1985, and October 8, 1985, we predicted that stock life insurers would pay the amount Congress expected for 1984, but that mutual life insurers would pay substantially less than what was expected (less than $1.2 billion, we predicted). In making this prediction of a serious shortfall on the part of the mutual companies, we expressed both our disappointment in the apparent misfunctioning of section 809 and our hope that, somehow, we would be proved wrong. Unfortunately, the Interim Report has confirmed our prediction and, with it, our disappointment.

II. The Interim Report and Stock Life Insurers

Congress expected that under the 1984 Act stock life insurers would pay taxes of $1.4 billion for 1984, or 45 percent of the $3.0 billion in taxes expected to be paid by the entire life insurance industry. The Interim Report finds that "[t]he stock segment paid approximately the same amount of tax after credits in 1984 as estimated at the time of the legislation," i.e., $1.4 billion. Interim Report at 16. However, according to the Interim Report, the $1.4 billion paid by stock life insurers represented 58 percent, not 45 percent, of the total taxes actually paid by the life insurance industry. With respect to 1985, Congress expected that stock life insurers would once again pay taxes of $1.4 billion for 1985, and the Interim Report finds that stock life insurers in fact paid more than that -- $1.6 billion.

The findings of the Interim Report show that stock life insurers paid exactly the amount of taxes expected of them in the first year under the 1984 Act, and paid even more than what was expected for 1985. But the findings also show that the relative tax burden of the stock life insurers exceeded significantly the 45 percent that Congress anticipated. The SIG believes that these findings speak for themselves: stock life insurers are paying the appropriate level of income taxes that Congress sought, and then some. The life insurance company provisions of the 1984 Act are thus operating as Congress intended with respect to stock life insurers, and no change in the 1984 Act is needed in this regard.

We noted previously that the SIG does disagree with the Interim Report's methodology and findings in one respect. The problem we have lies in the following statement on page 15 of the report:

> The taxes paid by the life insurance industry shown in Table 3.4 [summarized above] are determined on a life subgroup basis, allowing for losses from consolidated non-life companies to partially offset the life subgroup's taxable income and for some reallocation of tax credits between the subgroups. The use of the life subgroup after consolidation basis in this chapter permit comparison with revenue estimates made at the time of the 1984 Act.

In short, the Treasury is saying that the 1984 Act revenue estimates assumed the use of a portion of the losses and credits of life insurers' nonlife affiliates on consolidated tax returns. It therefore reported tax payments on an after-consolidation basis.

We do not understand how the Treasury can say this. First of all, we consider it doubtful that any data existed when the revenue estimates were developed in 1983-1984 from which life insurers' use of nonlife losses and credits could have been projected. A footnote to Table 3.4 indicates that life insurers' projected gain from operations (net income before deducting any policyholder dividends) had been reduced by nonlife affiliates' losses when the revenue estimates were made, but we frankly wonder how this could have been done. For one thing, no company had the ability to elect to file a life-nonlife consolidated return until it filed its tax return (for 1981) in 1982, while most of the data used in 1983 in projecting the 1984 Act revenues was drawn from *life insurance* industry statistics and tax returns prior to 1979.

Second, though, and more importantly, we submit that it was incorrect, as a matter of tax theory and statutory design, to take the effects of life-nonlife consolidation into account in developing estimates of life insurance companies' taxes. The purpose of Congress in rewriting the rules in 1983-1984 was to structure an appropriate tax system for life insurers, not for their nonlife affiliates. Determining the amount of taxes expected to be paid by life insurers after allowing for an offset of the losses of nonlife affiliates distorts this picture. The Interim Report acknowledges this, we think, when it also observes (again on Page 15):

> In evaluating the tax rules of life insurance companies, however, it may be appropriate to examine the tax law effects of the life subgroup before consolidation with non-life companies.

We therefore urge that in the construction of any future revenue estimates involving changes to the life insurance company tax rules, where the focus is the propriety of the tax burden in light of the companies' own economic income, the estimates should be developed *before* the effects of life-nonlife consolidation. We enclose with this statement, for the reference of the Subcommittee, a separate paper that we previously developed on this subject.

Had the ultimate findings of the Interim Report been stated before life-nonlife consolidation, the amounts of taxes paid by the stock segment for 1984 and 1985 would have been shown to be substantially higher. Based on other figures provided in the Interim Report, which were determined before life-nonlife consolidation (and before reductions by tax credits), the stock segment paid taxes of $1.76 billion for 1984 -- $360 million more than the original $1.4 billion estimate -- and $2.12 billion for 1985 -- $720 million more than estimated. 4/ Based on these corrected figures, the taxes paid by the stock segment far exceeded what Congress anticipated.

III. The Interim Report And Mutual Life Insurers

Congress expected that under the 1984 Act mutual life insurers would pay taxes of $1.6 billion for 1984, or 55 percent of the $3.0 billion in taxes expected to be paid by the entire industry. The Interim Report, however, finds that "[t]he mutual segment paid less tax in 1984 than orginally estimated . . . ." Interim Report at 16. According to the Interim Report, mutual life insurers paid only $1.0 billion for 1984, or $1.35 billion including the "true-up" for 1984 actually paid on the 1985 tax returns. Hence, the mutual segment fell short of the 1984 projected revenue by $350 million, after taking the true-up into account, and by $700 million without regard to the true-up.

With respect to 1985, Congress expected that mutual life insurers would pay taxes of $1.7 billion. According to the Interim Report, however, mutual life insurers paid only $1.3 billion for 1985, a full $400 million short of the congressional projection. Indeed, after the true-up, the 1985 tax payments of the mutual segment amounted only to $600 million, more than $1 billion short of projection.

For 1984 and 1985 combined, the **accumulated shortfall** of the mutual segment is quite stunning. Disregarding the true-up, it amounts to **$1 billion**, which is **almost one-third of the tax** that Congress expected to collect from mutual life insurers. Taking full account of the true-up, the mutuals' shortfall for the biennium totals **$1.35 billion**, or **more than one-third of tax** expected by Congress.5/

The findings of the Interim Report show that the mutual life insurers have not paid the taxes expected of them under the 1984 Act, by an impressive margin, and have not borne the relative tax burden that Congress concluded was appropriate. The life insurance company provisions of the 1984 Act are not operating as Congress intended with respect to mutual life insurers, and significant changes to 1984 Act -- section 809, in particular -- are needed to address this problem.

What has caused this problem? Frankly, Mr. Chairman, we are not completely sure, although the source of the difficulty cannot be anywhere other than in section 809. In the Interim Report, the Treasury acknowledged that the data utilized by revenue estimators in 1983-1984 to determine the structure of

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4/ Tax credits were minimal in 1984 and 1985, according to the Interim Report. *See* Interim Report at 21, 26.

5/ Before life-nonlife consolidation and before tax credits, the mutuals' tax payment figures rise slightly. The nonlife losses depress the mutuals' tax payments by approximately $80 million for 1984 and $180 million for 1985.

section 809 were seriously flawed. At the heart of section 809's mechanics is the "imputed" earnings rate, set by statute at 16.5 percent for 1984. The 16.5 percent rate was based on the estimators' assumption, among other things, that the mutual's aggregate "equity" as calculated under yet another provision of section 809 would be $37.4 billion in 1984. But that equity, as subsequently reported by the mutual companies on returns filed with the Government, turned out to be $5 billion less ($32.1 billion).

Hence, it has become evident that section 809's 16.5 percent rate is simply, and significantly, too low to produce the expected level of revenue. Were that rate to be increased, perhaps to a rate in the neighborhood of 21-22 percent (which would more closely approximate an equity return-type rate), much of the shortfall probably would disappear. But we cannot assure you that all of it would, and that the original expectations would then be met.

Beyond the deficiency in the 16.5 percent rate, the Interim Report speaks of the possibility of "tax-minimizing behavior" on the part of the mutual segment (Interim Report at 16, 18), but it does not elaborate on this. At the bottom line, mutual life insurers have somehow been able to deduct a greater percentage of their policyholder dividends, and thus pay less tax, than Congress expected. The SIG does not know how mutual life insurers have accomplished this in all respects, which is a question best addressed to the mutual segment itself. The one thing that is clear, however, is that section 809 simply is not producing the level of income taxes from the mutual segment that Congress deemed appropriate when it enacted the 1984 law.

IV. Conclusion

Congress enacted the life insurance company provisions of the 1984 Act following the fundamental premise that all life insurance companies should be fully subject to income taxes according to a stock life insurance company model. The findings of the Interim Report show that stock life insurers are paying an appropriate level of income taxes, in line with Congress's expectations under the 1984 Act. Accordingly, no change is necessary in the way that stock life insurers are taxed under the 1984 Act.

On the other hand, the findings of the Interim Report show that mutual life insurers are not paying income taxes at the level expected by Congress. Beyond the obvious fact that section 809 is not working as intended, the reasons for this are not clear. How the revenue shortfall for the mutual segment occurred, and what should be done about it, are issues that Congress and the Treasury Department should resolve.

As further efforts are undertaken to grapple with the shortfall in mutual life insurers' tax payments, we anticipate that a number of questions will arise. For example, some will undoubtedly question, as the Treasury apparently has in the Interim Report, whether the role that "segment balance" played in framing the 1984 Act was appropriate. To recall the pertinent history and otherwise aid in the Subcommittee's future deliberations on the point, we enclose with this statement, for the Subcommittee's reference, a paper we prepared last year, appropriately entitled "Why Segment Balance?" You will also hear about a theory, attributable to Professor Michael Graetz, that section 809 should be repealed altogether because Congress made a mistake in enacting any limitation on dividend deductibility under the 1984 Act -- a mistake, it is said (intriguingly), that has caused the mutual companies to be *over-taxed*. We do not think this theory has any merit, as we explain in another paper that we submit with this statement for the Subcommittee's reference.

In offering such assistance, we do not mean to detract from our stated conviction that the deficiencies in section 809 should be worked out in conjunction with the *mutual* companies. We are encouraged by efforts now underway within the American Council of Life Insurance, fully supported by mutual and stock companies alike, to provide for an all-industry agreement on what this solution should be.

For our part, the principal concern of the SIG is only that any solution here be a fair one to all life insurers, who are in competition with one another. Taxes are a significant component of the competitive equation. Stock life insurers do not wish to interfere with the function of Congress in determining adequate levels of revenues from various classes of taxpayers, but stock life insurers do want to survive. Unless mutual life insurers and their owners are taxed in the same manner as stock companies and their owners, market considerations will foreclose to stock companies the opportunity to compete.

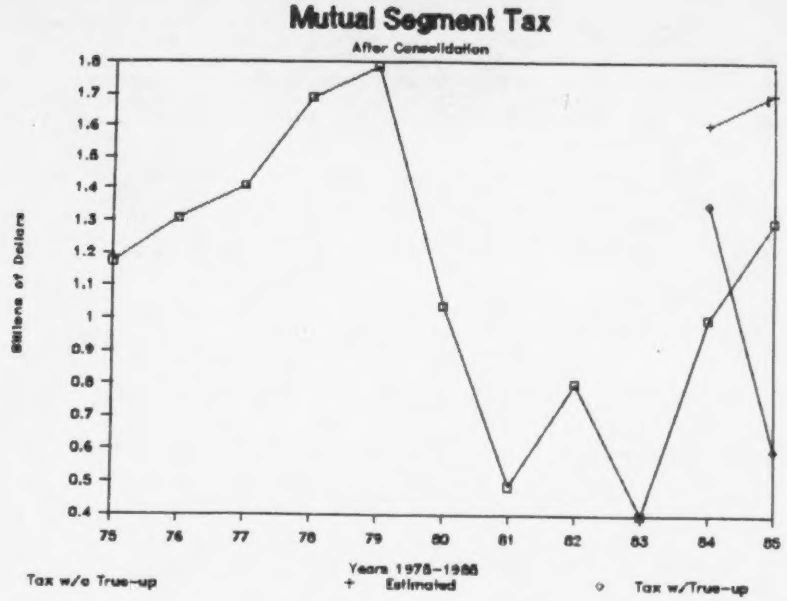
The member companies of the SIG appreciate this opportunity to offer their views to the Subcommittee.

Respectfully submitted,

William B. Harman, Jr.
DAVIS & HARMAN

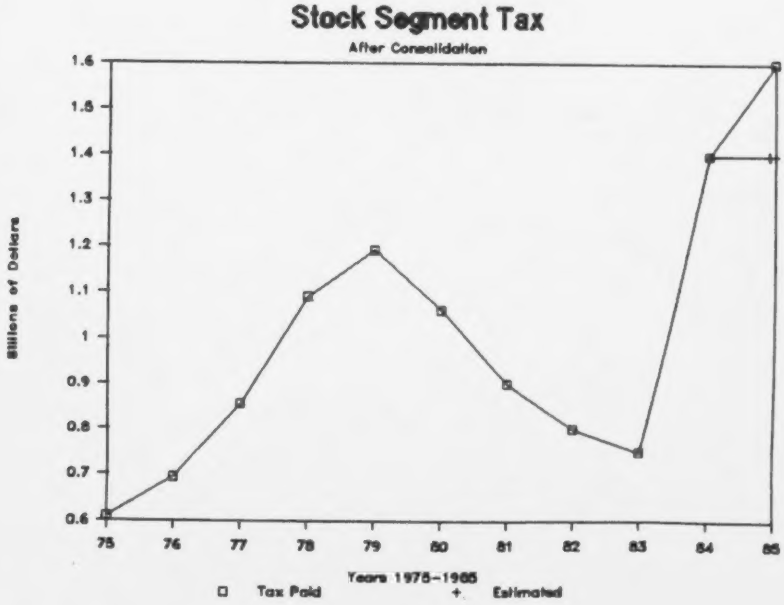
MEMBERS OF THE STOCK COMPANY INFORMATION GROUP

Aetna Life & Casualty Company
Allstate Life Insurance Company
American General Corporation
Business Men's Assurance Company of America
Capital Holding Corporation
CIGNA Corporation
CNA Insurance Company
Federal Kemper Life Assurance Company
First Capital Life Insurance Company
Franklin Life Insurance Company
Hartford Life Insurance Company
ICH Corporation
IDS Life Insurance Company
Integon Life Insurance Corporation
Jefferson-Pilot Life Insurance Company
Liberty Life Insurance Company
Life Insurance Company of Georgia
Life Insurance Company of Virginia
Lincoln National Life Insurance Company
Monarch Capital Corporation
Paul Revere Life Insurance Company
Provident Life and Accident Insurance Company
Torchmark Corporation
Transamerica Occidental Life Insurance Company
Travelers Insurance Company
Washington National Insurance Company



Mutual Segment Tax

After Consolidation



Stock Segment Tax

After Consolidation

Chairman RANGEL. Thank you, Mr. Harman.

Mr. Schuenke.

STATEMENT OF DONALD J. SCHUENKE, CHAIRMAN, MUTUAL LIFE INSURANCE COMPANY TAX COMMITTEE, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, NORTHWESTERN MUTUAL LIFE INSURANCE CO., MILWAUKEE, WI; ACCOMPANIED BY THEODORE R. GROOM, COUNSEL, MUTUAL LEGISLATIVE COMMITTEE, AND PARTNER, GROOM & NORDBERG, WASHINGTON, DC

Mr. SCHUENKE. Good morning, Mr. Chairman, and Members of the committee.

I am Donald J. Schuenke, chief executive officer of the Northwestern Mutual Life Insurance Company in Milwaukee, Wisconsin.

I'm appearing today in my role as chairman of the Mutual Life Insurance Company Tax Committee. The Mutual Life Insurance Company Tax Committee is an organization of mutual life insurers, interested in the application of Federal income tax laws to its members.

The committee has 65 member companies. I am accompanied by Ted Groom, cocounsel to the mutual committee.

We welcome this opportunity to appear before the committee to present our views.

First, let me say that we applaud the Treasury Department's work on the interim report, and its development of a data base that, when completed, should greatly assist this committee in its current effort.

Today mutual companies would like to make three basic points.

First, mutual companies believe that the concept of segment balance just doesn't make sense. It doesn't make sense to tie the amount of income taxes to respective shares of such items as equity, assets, or premiums.

I'm not a tax expert, but I think it's common knowledge that Federal income tax is imposed on income, and the state tax is imposed on wealth, and property tax is based on assets; sales tax is based on gross receipts.

But an income tax is supposed to be based on income.

Segment balance also makes no sense because it's unnecessary. The income of each mutual company can be measured directly. We don't need segment balance to approximate the income earning capacity of the mutual life insurance company segment.

We will also hear shortly from Professor Graetz about his prepayment analysis, which clearly demonstrates that income of mutual companies can be precisely measured in a way entirely comparable to the measurement of income of stock life insurance companies.

Segment balance doesn't make sense because as the interim report indicates, future revenues cannot be predicted with any degree of accuracy.

The tax laws themselves, the dynamics of the life insurance industry, the macroeconomic conditions, generally are too complex to predict what taxes will be paid in the future by any industry or by any segment of an industry.

Are we in the dawn of a new age of the Federal income tax laws where revenue estimates are established and companies must ante up if they fall short? If they exceed their targets, do they get a refund?

If this is the dawn of a new age, we believe that the interim Treasury report and other available data demonstrates the mutual segment of the industry has been shrinking, and today represents less than 40 percent of the life insurance industry.

Moreover, mutual life insurance companies comprise only about 20 percent of the entire insurance industry, which perhaps is the best measure under a segment balance approach.

We urge you to tax all life insurance companies on their economic income, and as far as segment balance goes, let the chips fall where they may.

Second, mutual life insurance companies believe that section 809 is fundamentally flawed. It is flawed because it's based on a faulty premise that mutual companies would have an inherent tax advantage if they received a full deduction for policyholder dividends.

Professor Graetz' prepayment analysis convincingly refutes that premise.

Section 809 is also flawed because it selects the mutual industry as the only mutual form of organization that is subject to an ownership differential tax.

For example, mutual savings and loan and mutual property and casualty insurance companies do not pay a similar ownership differential tax.

As the only form of mutual organization that pays this special ownership tax, mutual insurers believe that section 809 can fairly be characterized as a tax penalty imposed primarily for competitive reasons.

Section 809 is flawed in the extreme because it makes each mutual company's taxable income dependent upon the performance of its competitors, both stock and mutual.

We understand that the final Treasury report due at the beginning of next year, will reevaluate the basic assumptions on which section 809 is founded.

We eagerly look forward to the Treasury's conclusions.

Third, whether measured by our income, or by our share of the business, we believe that mutual companies paid more than an appropriate amount of taxes, both in 1984 and in 1985.

In fact, as described in my written testimony, based on actual taxes paid, the effective tax rate for mutual companies for that period was higher than the effective tax rate for all corporations and nearly twice the effective tax rate for stock life insurance companies.

In summary, Mr. Chairman, we agree with Treasury's conclusions that tax legislation should attempt to measure income accurately, and that it is inappropriate to attempt to collect a particular amount of revenue from segments of an industry.

We also believe that section 809 is flawed in concept, and we look forward to the Treasury's evaluation of its merits.

And third, under the 1984 act, mutual companies paid a very high level of taxes when compared to their income, even if measured by the artificial standard of segment balance. The taxes paid by mutual companies were more than commensurate with their actual presence in the marketplace.

Mr. Chairman, we are of course mindful that eliminating section 809 would reduce tax revenues, and we recognize that in times of budget deficits, revenue losing proposals, however meritorious, may be hard to accept.

In view of this, mutual companies are willing to explore tax changes that replace revenue losses which would result from the repeal of section 809.

However, all such changes should measure income more accurately, and apply to all companies on a fair and equitable basis.

Let me say in closing that we believe that the 1984 Act was a good faith effort on the part of Congress to deal with a very difficult subject under considerable time pressures.

However, we believe that the current law can be and must be substantially improved.

[The statement of Mr. Schuenke follows:]

September 27, 1988

STATEMENT OF DONALD J. SCHUENKE

Good morning, Mr. Chairman and Members of the Subcommittee. I am Donald J. Schuenke, President and Chief Executive Officer of The Northwestern Mutual Life Insurance Company in Milwaukee, Wisconsin. I am appearing today in my role as Chairman of the Mutual Life Insurance Company Tax Committee. The Mutual Life Insurance Company Tax Committee is an organization of mutual life insurers interested in the application of Federal income tax laws to its members. The Committee has 65 member companies. I am accompanied by Ted Groom, Co-Counsel to the Mutual Committee.

We welcome the opportunity to appear before this Committee to present our views on the Treasury's Interim Report on the operation of the 1984 Life Insurance Company Tax Act. Let me first say that we appreciate the work that the Treasury Department has begun and reported on in its Interim Report and look forward to the development of a data base that, when completed, should greatly assist this Committee in its current effort.

Today mutual companies would like to make three basic points as you begin your reexamination of the 1984 law:

1. "Segment balance" and the setting of revenue targets for the life insurance industry and mutual and stock segments should be abandoned.
2. Section 809 is fundamentally flawed.
3. During 1984 and 1985, mutual life insurers paid more than their fair share of tax.

I would like to elaborate briefly on each of these points.

Our first major point is that the concept of segment balance just doesn't make sense. This concept--unique to life insurance company taxation--is actually a witches' brew of three mistaken beliefs. One mistaken belief has been that economic income of mutual life companies cannot be measured directly. A second mistaken belief has been that economic income of mutual life insurers can be accurately approximated by reference to some indicia of business size like assets, equity or insurance in force. Still another mistaken belief has been that revenue targets can be set for the life insurance industry and then allocated to the segments in proportion to measures of segment size that have no direct relationship to income.

By 1988, each of these fallacies has been subject to ample tests of time and practical experience, and each has totally failed the test.

With respect to the first fallacy, we now know that the income of a mutual company can be measured directly. Professor Graetz's prepayment analysis, which I will subsequently discuss in more detail, clearly demonstrates that income of mutual companies can be precisely measured in a way entirely comparable to the measurement of income of stock life insurance companies.

As to the second fallacy, no measure of size or business activity taken in isolation or in combination can accurately predict net income. Corporations with large assets become insolvent and companies with substantial capital have widely varying rates of return. In fact, the existence and relative amount of net income depends on relatively small changes in expenses and gross income, marginal differences in calculations involving risk, and differences in managerial abilities that no economist or insurance expert has been able to quantify.

Finally, I am not a tax expert, but I thought it was common knowledge that the Federal income tax is imposed on income. An estate tax is based on wealth; a property tax is based on assets; a sales tax is based on gross receipts . . . . And an income tax is supposed to be based on income, not on some notion of segment balance.

Are we on the dawn of a new age of the Federal income tax laws where revenue estimates are established and companies must ante up if they fall short? If they exceed their targets do they get a refund? If this is the dawning of a new age, we believe that the Treasury Interim Report and other available data demonstrate that the mutual segment of the industry has been shrinking and today it represents not 55 percent, but less than 40 percent of the life insurance industry. Moreover, mutual life insurance companies comprise about 20 percent of the entire insurance industry, which is the best measure under a segment balance approach. In today's intensely competitive environment, mutual life insurers are no longer the dominant segment in life insurance that we were in the 1950's. We face competition in the life insurance business from American industry's leaders such as ITT, Transamerica, American Express, and Sears. We also compete with huge insurance conglomerates which are able to use their extensive property and casualty operations to provide synergistic benefits in the tax arena. All mutual life companies--large and small--must vie against corporate giants with unlimited access to capital markets.

We urge you to tax all life insurance companies on their income and, so far as segment balance goes, let the chips fall where they may.

Our second major point is that section 809 is fundamentally flawed. It is flawed because it is based on a faulty premise that mutual companies would have an inherent tax advantage if they received a full deduction for policyholder benefits. Careful economic analysis undertaken since 1984 demonstrates that section 809 is unjustified and should be discarded. This analysis was undertaken primarily by Professor Michael Graetz of Yale Law School and is widely known as the "Prepayment Analysis." Although the mathematics of the analysis can get complicated, the basic elements of the theory are fairly straightforward. While mutual companies deduct policyholder dividends, mutual companies include in income all premiums they receive, including any amounts that might be considered capital payments. On a present value basis, this system is mathematically equivalent to the stock company system of excluding capital receipts from income and not deducting shareholder dividends. In other words, section 809 is totally unnecessary to provide tax parity between mutual and stock life insurance companies.

The prepayment analysis has been endorsed by a number of leading tax experts. Here's what the experts say about the prepayment analysis:

Economist Henry Aaron:

- "Graetz's argument that mutual companies are effectively taxed by the inclusion of premiums in the tax base . . . is straightforward and, I think, correct."

Gregory Ballentine, former Deputy Assistant Secretary of Treasury:

- "Graetz has presented an important equivalence theorem that should be the basis for future discussions of the tax treatment of mutual companies versus stocks."

Daniel I. Halperin, former Deputy Assistant Secretary of the Treasury:

- "I believe Professor Graetz is correct and that his conclusion is adequately supported by the algebra in his paper."

Section 809 is also flawed because it selects the mutual life insurance industry as the only mutual form of organization that is subject to an ownership differential tax. For example, mutual property and casualty insurance companies do not pay a similar ownership differential tax and some paid no corporate income tax during 1984 and 1985. Indeed, when Treasury recommended extension of the mutual life differential concept to mutual property and casualty companies in 1986, that recommendation was rejected by this Committee. As the only form of mutual organization that pays a special ownership differential tax, mutual life insurers believe that section 809 can fairly be characterized as a tax penalty imposed primarily for competitive reasons.

Section 809 is flawed also because each mutual company has income imputed to it based on a statutory formula without regard to its actual income. The concept that the mutual segment should be taxed on imputed income each taxable year is unique to U.S. corporate income taxation. An additional flaw is the fact that under section 809 the amount of the imputed income is dependent upon the performance of each company's competitors, both stock and mutual.

We understand that the final Treasury report due the beginning of next year will re-evaluate the basic assumptions on which section 809 is founded. We eagerly look forward to the Treasury's conclusions.

Our third major point is that mutual companies paid more than a fair share of tax in 1984 and 1985 relative to our income and share of the business. In fact, based on taxes actually paid to the Treasury, after giving full effects to consolidation, the effective tax rate for mutual companies for that period was higher than the effective tax rate for all corporations and twice the effective tax rate for stock life insurance companies.

The key issue in comparing relative tax burdens of stock and mutual life insurance companies is what taxes were actually paid relative to what income was actually received. Or, in other words, what were the effective tax rates of stock and mutual life insurance companies in 1984 and 1985?

Exhibit I to my statement reflects a dramatic difference in stock/mutual tax rates during this period: Exhibit I shows:

- Mutuals paid at twice the rate of stocks.
- Mutuals paid at a rate significantly in excess of all other corporations.
- Stock life companies had tax rates below those of most other stock corporations.

The comparison is based on actual tax payments of stock and mutual life insurance companies, as reported in the Treasury Interim Report, taking into account the benefits both segments received from consolidation, particularly the stocks. These tax payments are then compared with income reported on annual statements filed with state insurance departments. These statements provide an excellent basis for comparing income of mutuals and stocks because they are the only accounting statements prepared on a uniform basis by both mutuals and stocks that report all economic income.

Exhibit II to my statement also compares mutual and stock company effective tax rates by adjusting stock company income to the mutual company model. Mutual company income includes any capital that is received as part of the premium payment. It also is reduced by any equity returns included in policyholder dividends. In Exhibit II we measure stock company income in the identical manner--increasing their income by capital contributions and reducing their income by shareholder dividends. Since the income of both segments is measured identically, this method provides an excellent comparison of relative income tax-paying capacity. As you can see, this method does increase the stock company effective rate, but only slightly, to 17 percent--still well below the mutual company tax rate of 30 percent.

Why is the stock life company effective tax rate so low? There are several reasons. First, unlike mutual life insurance companies, stocks have no add-on tax. This is true even in cases where the stock life company is a wholly-owned subsidiary of a mutual property and casualty company and issues only dividend-paying business. It is also true even though many stock life insurance companies issue dividend-paying insurance products that are fundamentally the same as those issued by mutual companies.

Second, to the extent mutual life companies receive any equity capital, that capital is included in income, and it is subject to tax. Stock life companies receive their capital tax-free. While stock companies tend to downplay this advantage, our review of publicly available financial statements indicates that 19 of the largest stock insurance fleets received nearly $7 billion of tax-free capital during 1984-1986. Indeed, during this period, the tax-free capital they received exceeded their non-deductible shareholder dividends by over $1.6 billion.

Third, most major stock life insurance companies are affiliated with property and casualty companies. Because these companies receive very favorable treatment on municipal bond interest and dividend income, they are able to create substantial noneconomic tax losses. These tax losses can then be used in the consolidated return to offset life insurance company tax liability. Our review of financial statements shows that 18 of the top 40 stock insurance fleets had a negative effective tax rate or a tax rate below 10 percent in either 1984 or 1985, or both years. As a June 2, 1988 Wall Street Journal article indicates, this favorable treatment has continued even after the 1986 tax reform legislation. For example, the article shows that a number of large diversified stock companies with life insurance affiliates paid effective tax rates for 1986 and 1987 ranging from a low of zero percent to a high of only 13.6 percent.

In summary, Mr. Chairman:

1. We heartily agree with the statement at page 18 of the Treasury Interim Report, "that it is more appropriate for tax legislation to attempt to measure accurately the taxable income of companies than to attempt to collect a particular amount of revenue from an industry or from different segments of an industry."

2. We believe that section 809 is flawed in concept and we look forward to the Treasury's evaluation of its merits.

3. Under the 1984 Act mutual companies paid taxes at an effective tax rate nearly double that of stock companies.

Mr. Chairman, we are, of course, mindful that eliminating section 809 would cost money. We also recognize that in times of budget deficits, revenue-losing proposals, however meritorious, may not be tolerated. In view of this, mutual companies are willing to explore tax changes that replace revenue losses which would result from the repeal of section 809. We would consider such changes so long as the changes measure income more accurately and apply to all companies on a fair and equitable basis.

Let me say in closing that I believe that the 1984 Act was a good faith effort on the part of Congress to deal with a very difficult subject under considerable time pressures. However, we believe that the current law can be, and must be, substantially improved.

EXHIBIT I

LIFE INSURANCE COMPANY
EFFECTIVE TAX RATES
ANNUAL STATEMENT CONVENTIONAL BASIS
1984-1985
(in $ billions)

	Income	Federal Income Tax	Tax Rate
Mutual Life Companies	$ 6.9[1/]	$ 2.1[2/]	30%
Stock Life Companies	$ 15.8[1/]	$ 2.4[2/]	15%
All Corporations			22%[3/]

[1/] Income for mutual and stock life insurance companies is gain from operations plus capital gains as reported on NAIC Annual Statements.

[2/] Federal income tax for mutual and stock life insurance companies represents actual tax payments to Treasury determined by taking the proportional allocation figures for companies filing life/nonlife consolidated returns from Table 4.4 of the Treasury Interim Report and aggregating them with the separate life/life data from Table 4.2.

[3/] The tax rate for all corporations is from a report entitled, "Effective Corporate Tax Rates 1985," published by Tax Analysts.

EXHIBIT II

LIFE INSURANCE COMPANY
EFFECTIVE TAX RATES
ANNUAL STATEMENT RESTATED BASIS
1984-1985
(in $ billions)

		Income	Federal Income Tax	Tax Rate
Mutual Life Companies		$ 6.9	$2.1	30%
Stock Life Companies				
Conventional Income	$15.8			
Capital Receipts	1.9			
Shareholder Dividends	(3.6)	$14.1	$2.4	17%

Basis of Computation:

1. Same as Exhibit I with stock life company income restated to the mutual model to include capital receipts and to deduct shareholder dividends.

2. Shareholder dividends are the average of the two reports of shareholder dividends in Table 4.6 of the Interim Report of the Treasury Department. Capital receipts are from A.M. Best data.

Chairman RANGEL. Thank you.

I see you have some concerns about what the Congress did in 1984, and I'm glad that Pete Stark is here.

I was under the impression that the industry had joined in and was supporting section 809. Were you people involved at all?

Mr. SCHUENKE. I think that's true. I think both the stocks and the mutuals in 1984 agreed to a method of taxation which was expected to produce a certain result. However, in fact it didn't.

Chairman RANGEL. So when you say that the Congress made a terrible mistake, it was based on faulty advice from the experts, would you?

Mr. SCHUENKE. Well, first of all, I didn't say that the Congress made a terrible mistake.

Chairman RANGEL. I think you said worse than that, really.

Mr. SCHUENKE. I said it was a very good faith effort to solve a very difficult problem; but it needs more work.

Chairman RANGEL. I apologize. Mr. Harman said that Congress made a mistake in enacting this. [Laughter.]

Mr. SCHUENKE. Mr. Harman's a tax lawyer; I'm just a businessman.

Mr. HARMAN. Mr. Schuenke is a lawyer, too.

Mr. MCGRATH. Did Mr. Harman actually say that?

Chairman RANGEL. Well, it was probably in his statement; he probably didn't say it.

Mr. HARMAN. I think, Mr. Chairman, I did say that the Congress did an outstanding job on the stock side in 1984, and we do not believe any change is necessary in that regard.

On the mutual side, as Professor Pike pointed out, since 1909 has been a very serious difficulty in determining how to properly limit the deduction of mutual life insurance companies' dividends.

I think my statement was an indication that the Congress, at least in the views of the stock companies, did not do as good a job in 1984 in limiting it properly as it had done in the past.

We think that it does need to be looked at. I suspect Mr. Schuenke would go one way on it, and the stock companies might go another way on it.

Chairman RANGEL. OK. Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman. I think it is proper to recall that the mutual companies, as a group, enthusiastically supported the changes in 1984, although I might suggest that Mr. Ferguson was probably the least enthusiastic of all the enthusiastic supporters, to the credit of Northwestern.

I would also repeat that I think that the committee and the committee staff would be more than willing to look at changing 809. But I think we are inclined to believe that any changes, proposed changes, that we've ever heard of, would do one of two things. They would either be equally as bizarre as what we have now, or they would allow major companies to zero out. Given that choice, living with the bizarre seems to be a better choice that living with no revenue.

And third, that there have been studies, if consistency is the hobgoblin of small minds, then mutual companies have the highest foreheads in the world. The Garber study only 1 year ago concluded, as I understand, the exact opposite of Professor Graetz' study, and was also paid for by the mutual industry.

Now, I'm sure that the stock industry could find some consultants to come up with studies as to why we should continue to allow consolidation. But I'm sure that the mutuals could also find some studies why we shouldn't. It does seem to me that there is some risk, and risks might be sending 1099s to policyholders, premium taxes. I mean there are a whole bunch of creative ways to tax the insurance industry.

What I would submit is that I think a lot of people in good faith came up with a program that, at least in my opinion, and based on the testimony from Treasury and GAO, is working about as well, or as poorly, as we thought it would. It may be off a buck here or a buck there. Some companies may find it works more to their advantage or disadvantage than others. But for a shot in the dark, I don't think we did badly.

The issue is such that I think it could get a lot worse. And all I would suggest to the witnesses who understand these problems far more than do I and in many cases, our staff, is, we ought to see another year or two go by.

It's my indication that the mutual industry in 1988 did about $1 billion in refunds. They make it look a whole lot better than the couple of years in this study.

I'm not sure what their testimony will be at that point, or what Mr. Harman's testimony will be at that point.

I think that in the absence of some unanimity, both as to what you would do to ascribing the equity in a mutual company to policyholders to liquidation, depending on how you tax them, that we limp along with the present system, and continue to look at what it yields, with the assurance that this committee would, if we saw things that seemed very unfair to one group or another, would try and change it.

But I think that the data that we've gained in this study is helpful. I think we should continue to look closely at it. And I think that the industry will prosper and I hope make a lot of money; pay us a lot of taxes so we'll have less deficit.

[The Garber study was subsequently submitted by Mr. Stark. Direct testimony continues on p. 197.]

TASK FORCE ON MUTUAL LIFE INSURANCE COMPANY CONVERSION

Moderator:	HARRY D. GARBER
Panelists:	DANIEL J. MCCARTHY
	HENRY B. RAMSEY, JR.
	WALTER SHUR
Recorder:	WILLIAM C. KOENIG

o A discussion of the committee's final report.

MR. HARRY D. GARBER: I am the Chairman of the Task Force on Mutual Life Insurance Company Conversion. The purpose of this session is to solicit comments on the Task Force report. The panelists will make some brief comments about specific portions of the report in hopes of stimulating discussion.

The first thing I would like to do is list the members of the Task Force who contributed to this effort: Bob Lindsay and Lou Roth of MONY, Dale Gustafson (who retired in the process) and Jim Murphy of the Northwestern Mutual, Bob Lowden of John Hancock, Curtis Huntington of New England, Mike Cowell of State Mutual, Bob Winters, Doug Murch and Ed Price of Prudential, Ed Slaby of Unity Mutual, Jim Tilley of Morgan Stanley, Bob Shapiro who was with Merrill Lynch when he started with us and then started his own firm, Dan McCarthy and Dale Hagstrom of Milliman and Robertson, Hank Ramsey of Penn Mutual, Walt Shur of New York Life, Steve Smith with Union Mutual (now UNUM), Charlie Greeley with Metropolitan, Robin Leckie and Gary Corbett with Manufacturers (although Gary, again, shifted along the way), Jim Wertheimer of Massachusetts Mutual, Mike Berkowitz of Mutual Benefit, and John Elken of Principal Mutual. We had most of the large mutual companies represented.

The Task Force worked hard and effectively and did an outstanding job in dealing with this issue. We are very pleased with the report. The report was discussed briefly by the Board of Governors and we were authorized to issue it as an expression of opinion of the Task Force. Also, it will be printed in full in the *Transactions* Vol. 39. It is important that, if there are differences of opinion relating to the conclusions of the Task Force, we use this opportunity to get them into the *Record*.

Let me give some general background. We started by saying that in the conversion process there are usually three interested parties. There is the company itself which is interested in accumulating capital, changing structure, or has some other reasons to convert. The policyholders are interested in preserving their guaranteed benefits, continuing their dividend treatment (whatever that is) and also in receiving fair compensation for the surrender of their membership rights. If the conversion involves raising new capital in the public markets, the new shareholders are the third interested party. Nothing will happen unless all three parties are satisfied that their interests are being met. It is important to remember this when we get to the subject of compensation for policyholders. If the required standard is so high that no shareholder will buy into the company, all that standard does is prevent a conversion.

This analysis permitted us to identify three important issues. First, how can we assure reasonable policyholder dividend expectations? Second, what constitutes the aggregate amount of fair value to distribute to policyholders in a conversion process? And third, how should that fair value be allocated among policyholders? The report addresses each of the issues in appropriate depth. We chose to cover these subjects very broadly rather than get into detailed exploration of the relevant actuarial issues.

Finally, we had some side products from our work. We developed a computer model which the Task Force used in its analyses. We explored, in depth, the issue of management accounting for mutual companies, and there was a report issued by a subgroup of this Task Force and published by the Financial Reporting Section. I commend it to you if you are interested in that subject. Finally, we studied the issue of what the appropriate model is of mutual company financial operations.

Let me start with a few comments on aggregate compensation. Then Dan McCarthy will talk about the closed branch, Walt Shur will discuss the allocation of the aggregate amount, and Hank Ramsey will finish with a talk about mutual company capital management practices and related issues.

The question of aggregate compensation to policyholders is one that many people have considered over the years, but not much analytical work has been done. We concluded that there is no recognized basis for determining an amount of distribution, either in the aggregate or policy-by-policy. In fact, there were no guidelines anywhere in practice, in theory, in law, in rights, or in expectations that had any substance other than that someone had used them or thought of them. This doesn't mean that the policyholders should not receive compensation for surrender of membership rights, but as far as we could tell, there was no recognized basis for determining what that amount should be or how it should be allocated. Those of you who followed the travails of the Union Mutual conversion process found out that what was said in law did not turn out to be what was required in fact. Even those people who might rely on the Williams Law for substance would not find much comfort from that proceeding.

So how do we start on this? The report states, "It is clear that, before conversion, a mutual life insurance company has neither an established market value nor an accepted way of defining ownership interests. These values must necessarily emerge as part of the conversion process itself and as the analyses in this section demonstrate clearly, they are affected importantly by the company's circumstances and the general state of the public equity markets."

We started by concentrating on cases involving an initial public offering. We thought that these raised all of the issues and were the most complex to deal with, but we don't mean to imply that this would be the predominant form of conversion. We recognized that this particular area is not primarily an actuarial problem, but as we were the only game in town, we took it on nonetheless because we thought we had some useful things to say.

We started by taking our three interested parties: the company, the policyholders, and the prospective shareholders and working from there. We introduced some formulas, which I would describe as descriptive rather than analytical, and used the results to illustrate certain relationships. The Task Force was struck by the wide range of results that were possible for policyholder compensation, depending particularly on the relationship of the company's book to market value as it eventually emerged in a public offering, and on the amount of capital being raised. In some extreme cases involving the raising of large amounts of capital, the company could be accused of acting imprudently relative to its policyholders. It is not unlike situations that arise in public companies where new issues of stock of a very large size could dilute the interests of existing shareholders. The main difference is that in this case we don't start with an initial share value. In fact, we don't start with a value of the company at all, and therefore the question of whether there was a dilution is one that can never be answered conclusively.

Our conclusion in this area was that there was no generally applicable standard. One must recognize in the process that each company's circumstances are different. What an individual policyholder, or policyholders in aggregate, might get in any company conversion is dependent very importantly on that company's situation.

Our suggestion is that the insurance law should contain more than one method of conversion. Second, whatever value the insurance law specifies for policyholder compensation should be regarded not as the appropriate value but as a safe harbor value. So, if the company can provide at least that amount, the insurance department would accept that as reasonable compensation and only inquire into other aspects of the conversion.

MR. DANIEL J. MCCARTHY: The phrase *closed branch* is a kind of shorthand for discussion; a method of dealing with the issue of how to assure that participating policyholders of a company at the time of conversion will continue to have participation after conversion, in roughly the sense that they had it before conversion. How do you assure that dividend expectations (a somewhat loose term) are maintained in some fair fashion? We concluded that in certain cases you don't need to do much of anything. Market forces will take care of it. Imagine, for example, experience rated group insurance or group pension contracts. The tendency was to conclude that market forces would tend to take care of their participation first of all because it is related specifically to the experience of each contract, and second, because the company has almost no discretion in the way it treats those customers. On the other hand, there are policies that have the following kinds of characteristics, of which individual life is the most obvious. First of all, the amount of dividends expected to be paid in the future is substantial and will often have been illustrated as part of a sale. The company will have considerable discretion as to the amount and timing of dividends payable. There will tend to be averaging of experience across broad classes of policies. We felt all of those criteria point to the need for some kind of device to assure that participation is managed in the interests of those policyholders over a future period of time. The concept of a "closed branch" is what the Task Force examined in most detail as the device for maintaining such participation.

Conceptually, the closed branch is very simple. It is an accounting device which says "put aside enough assets so that if conditions continue as they are now, that fund together with future premiums and interest, and minus expenses, claims, dividends and so forth, will provide policyholders with the same dividend scale that they have now." The fund will ultimately wind down a good many decades, as the last of those policies ceases to exist, and policyholders will have gotten the dividends they had anticipated getting in the meantime. As for whether a closed branch should be established, the report says it is probably appropriate whenever contracts have the feature of a substantial amount of dividends expected, or have the concept of company discretion, or have the concept of averaging rather than specific experience rating. As a practical matter, you ought to have a group of policies which would be expected to diminish and disappear over time. A set of group insurance policies would not necessarily do this.

Assume for the minute that there is to be a closed branch. What kinds of questions have to be dealt with? You can separate them into two categories. How do you get it started, and how do you keep it going? Start-up questions deal principally with what assets ought to be assigned to the closed branch. How do you select them? How do you determine their amount? Maintenance questions include what kinds of income and expense do you expect will be credited to and charged against the closed branch over time?

It seems fairly obvious that we should assign to the closed branch the premiums, claims, and dividends associated with the policies assigned to the closed branch. It is a little less clear whether the closed branch should be set up in such a way as to charge actual maintenance expenses to it, or whether you would set up a closed branch in which you did not expect to make those charges. There are similar arguments to be made for federal income taxes. The report sets forth those considerations in some detail. As you will hear in Walt's comments, it depends to a certain extent on whether there is linkage between the establishment of the closed branch and the determination of the amount of compensation to policyholders. You may well wind up with different answers, depending on whether you have a linked system, which the Task Force is inclined to prefer, or an unlinked system, which was suggested by the statute and actually used in the Union Mutual case conversion.

Regardless of what you do, you can assume that the dividends payable will not be precisely those that would have been payable had the company continued to operate as a mutual, because the financial dynamics of a closed branch over time won't be the same as those of a company which continues to write new business. We suggested in the report that after the early years, during which the closed branch will continue to have positive cash flow, it is probably desirable to opt for stability rather than to expose those policyholders to a kind of disproportionate leveraged risk that would be associated with changing conditions. The report goes into some detail as to the kinds of assets and the kinds of cash flow characteristics that ought to be associated with the management of a closed branch, making it clear that these conditions are particularly important once the branch passes over from positive to negative cash flow. There are some numerical illustrations in the report. For the particular closed branch we illustrate, it takes, depending on how you read it, somewhere between 10 and 20 years to happen. There are some cases in practice (if they were to occur) in which the movement from positive to negative cash flow might happen sooner. The model that is illustrated in the report contemplated the issuing of traditional business in continually increasing amounts right up to the moment of conversion. Not every conversion would fit this mold.

The closed branch viewed as a separate entity would not be statutorily solvent. By and large, the carrying value of its assets would not be as large as its statutory liabilities. Therefore, as you contemplate the need for dividend scale changes over time, in order to be fair to policyholders as experience emerges, you can't use a statutory solvency test by itself. There are really two ideas you do have to work with. One is the concept of aiming at a target which is many years distant at the outset and closer later on, at which time the last dollar of assets will go to pay the last claim when the closed branch ends. We also suggest that it will be important to do experience analyses over time, almost in the way you would analyze actual to expected variations in a pension fund, to understand the nature of the changing experience and the need for and the nature of the changing dividend scales that would have to be developed in order to be fair to those customers. On the one hand you don't want the branch to run out of money, although to be sure, the stock company as an entity stands behind it. On the other hand, you don't want it to be a tontine. It will be a tricky exercise in practice to achieve the right balance. The report discusses in some considerable measure some of these issues, focusing particularly on the selection and management of assets. Also, there is some discussion of the kinds of actuarial opinions that will be required at the outset and over time in closed branch management.

MR. WALTER SHUR: During my remarks I am going to refer to Table 1. (Appendix 5 in the report). Once the aggregate amount of compensation is determined by market conditions, by the amount of capital that the company is raising, and perhaps by statute, the question then is how to distribute that amount to the individual policyholders. The only basis I could find in the law anywhere was one in the New York statutes. It says that if a company liquidates, and if after the company is totally unwound there happens to be any money left over, that money is to be given to the policyholders in proportion to the total premiums they have paid to the company since they have been with the company. That did not seem an appropriate basis for demutualization, maybe not even for a liquidation. After a lot of consideration the Task Force felt that a way to allocate the total compensation was primarily in proportion to the surplus contributed to the company by the various classes of policyholders. I use the word *primarily* for a specific reason. In a demutualization the policyholders are giving up some intangible membership rights like the right to vote. One could argue that they should get some compensation for that regardless of whether or not they left any surplus with the company. But overall we felt that an allocation in proportion to surplus contributed was a reasonable basis.

Start with the existing policyholders on the date of demutualization (those who are sharing in the distribution). Calculate the assets that accumulated from those existing policyholders and subtract from that the amount of assets placed in the closed branch on their behalf. The money placed in the closed branch is an amount of assets which, together with future premiums, is going to take care

TABLE I

ASSETS ACCUMULATED AT CONVERSION IN MODEL COMPANY ($ MILLIONS)

Approach to Calculating Assets Accumulated With Respect to Policies In Force	For Policies In Force	Terminated Policies	All Policies
1. Mechanical Method -	2679.0	(108.7)	2570.3
2. Cost of Insurance (COI) Charge	(325.6)	325.6	0
3. Approach 1: with COI Charge = 1 + 2.	2353.4	216.9	2570.3
4. Unamortized Acquisition Expense (UAE) Charge	(0.5)	0.5	0
5. Approach 2: with COI and UAE Charges = 3 + 4.	2352.9	217.4	2570.3
6. Approach 3:			
a. Accumulated Charges for the Cost of Capital	177.1	286.0	463.1*
b. Assets Assigned to Policies In Force (other than the assets corresponding to accumulated charges for the cost of capital)	2107.2	0	2107.2
c. Total Assets 6a + 6b.	2284.3	286.0	2570.3

* Of this amount, $16 million is attributable to the payment of lower dividend levels in the early years of the model company's financial operations.

of all the future benefits, the result being that all that money will go back to the policyholders. The assets they have accumulated, less the closed branch amount, represents all the past surplus contributed, plus the present value of any future surplus that they would have left with the company. That seemed like a rational allocation basis and an easy one for demutualizations incorporating a closed branch. We did think about such possibilities as using statutory reserves. We could take the assets accumulated, less statutory reserves, and use that as an allocation basis. That has a couple of problems. First, the statutory reserves are not likely to be equal to the amount which, together with future premiums, would exactly take care of the future benefits. A second practical problem is that most of the current policyholders have contributed negative statutory surplus. It is really not a very useful or practical allocation base.

We are all familiar with accumulating assets for a block of policies. If you take a block that was issued 30 years ago, we all know how to calculate the assets generated by that block. However, I think most of us are not used to trying to do that calculation for only those policyholders still existing here today. That is a very different question. If you try a cash flow analysis, you will see right away there is a problem. You collect premiums and investment income and charge expenses, but you find you have no death benefits because none of them have died, and you have no surrender benefits because none of them have surrendered, and the result is a very large number. If you took all of the policyholders who have terminated since that original date, and you do this simple cash flow analysis, you get a negative number because all of the death benefits and all of the surrender benefits are included. It became clear that to get the assets on the existing policyholders, there had to be some recognition of some things that have happened with respect to the terminated policyholders.

To explore that question we constructed a model company. The model company started 75 years ago, selling only participating whole life insurance. It had an 8% growth rate each and every year. It earned 8.65% on its nonloaned assets and 7% on its loaned assets. It paid income taxes of 36.8% of its gain. It also had an equity based tax which we set at 3% of surplus. The company ran for 75 years, at which point we presumed demutualization and calculated some pertinent items.

Looking now at Table 1, the company has $2,570 million of assets. As a first step, what we called the "mechanical method," we took the policies in force today and did a simple cash flow analysis, the result being $2,679 million. Similarly, for the terminated policies, the result was -$108.7 million, that being where all the death and surrender benefits were. Obviously, the problem here is the absence of any pooling of mortality charges between existing and terminated policies. We then calculated the cost of insurance for the policies in force over all those past years as $325.6 million. When we transfer that amount to the terminated side on line 2, we leave $2,353.4 million as the assets accumulated on the inforce policies, but we now have $216.9 million as the assets accumulated on the terminated policies. I think that is reasonable and easily understood.

We then looked at the question of surrender benefits. If you have a surrender and there is a loss at the time of surrender, is that something just like a loss incurred on death that should be charged against the continuing inforce policyholders? In the model company there was only a little surplus strain because of first year acquisition expenses. On line 4 we simply amortized the strain over six years and for terminations the unamortized expense was charged to the inforce policies. That made very little difference in this company because of the small strain. It transferred just $.5 million from the inforce to the terminated block. There are other approaches that could be used here, and other ways to define the gain or loss on surrender.

Approach 3 was the more interesting one. Here we took a different tack. In effect, we said that while they were in force those terminated policies were making use of company surplus. There was an amount of surplus that they were using or renting, if you will, and they ought to be charged for that use. First we defined the amount of surplus "used" by a policy. We took the statutory reserve, plus the dividend liability, plus 5% of the statutory reserves (which was the required surplus for the company), and subtracted the assets that had actually been accumulated by the policies to that time. That is the amount of company surplus they are using and for which they should be charged. We then did a long iterative process for a mature year of issue. We know how much surplus was developed by the time the last policy terminated, so we could solve for the percentage charge you would have to make on the surplus used each year to produce that final total. That turned out to be about 5.7%. For all terminated policies we went back and saw how much surplus they were using in each year, made the charges, and accumulated them. The terminated policies ought to have left that amount of money with the company, which added up to the $286 million shown on line 6a. Similarly, on the inforce, the accumulated charges were $177.1 million. The next line is just the balance of the assets, $2107.2 million. When you get down to the bottom, line 6c, total assets are $2284.3 million for the inforce policies and $286 million for the terminated policies. Approach 3 is just a different definition of what the terminated policies should leave with the company. To the extent they produce more or less than that, such differences are either credited to or charged against the inforce policies.

The 5.7% is an interesting number. You can derive it another way. T~~his company is~~ earning about 8.65% on its assets and is paying taxes of 36.8%, so that its after-tax rate of return is roughly 5.3%. Then ~~you~~ have an equity tax of 3% which when subtracted from 5.3% leaves 2.3%. This company is earning roughly 2.3% on its surplus. But the company is growing 8% a year. If you are going to maintain the same surplus ratio every year, the required surplus must increase by 8% a year. If it has only been increased 2.3% from the earnings on surplus, then the gains on the business (or those capital charges I talked about) have got to produce the other 5.7%.

Lastly, there are other questions to consider in determining these numbers. What classes should you use? The Task Force felt you should stay with the dividend classes you have used in prior years. It might be reasonable to combine some of these if you feel that the dividends have balanced the classes out, and so, from a surplus point of view, they are not different. For practicality you might combine some. Then there are questions of exactly what charges to make. What do you do with capital gains and losses, guarantee fund assessments, catastrophes, or transfers from one line of business to another line of business to eliminate a deficit? In general, those things ought to be handled, to the extent you can, consistently with dividend practices in those prior years. We don't see conversion as an opportunity to change or undo the dividend practices of past years.

MR. HENRY B. RAMSEY, JR.: I am going to comment on three aspects of the Task Force work. First, I would like to identify what appear to me to be the most important conclusions in the report. Second, I would like to talk a little bit about the increased knowledge of the role of capital which grew out of the Task Force work. Finally, I would like to make a few comments on the process itself.

I would cite five items as the most important conclusions from the Task Force work. Probably the most important clear conclusion reached was that the amount which can be paid to policyholders for membership rights is totally dependent on free market considerations, on the stock price which the marketplace will support at time of conversion. The Task Force recognized that the marketplace assessment of the value of the company will depend upon two things: (1) a valuation of existing business, which involves a valuation at a market earnings rate of the capital cash flows related to that business over the future, and (2) the expectation of the earnings that will be realized on new capital investments by the company. That in turn will be dependent upon the performance record of the company with respect to its recent capital investments. This means that legislation must be flexible and not rigid with respect to the magnitude of payment to policyholders for membership rights.

Another critically important conclusion reached is that most mutual companies have significant amounts of entity capital, that is, capital that is not intended to be returned to existing policyholders. This makes it more likely that there will be value available to pay for membership rights.

A third important conclusion is that the establishment of a "closed branch" type accounting technique should create an effective and an adequate vehicle for paying reasonable policyholder dividends to existing policyholders, thus making that a practical operation.

An important conclusion not contained in our primary report, but rather in the report of the Accounting Subcommittee, is that the "Level Return on Equity" accounting method is the most appropriate accounting standard for management reporting in a mutual life insurance company. This is remarkable in several ways. First, mutual companies would endorse a capital-related form of accounting, and second, a group of senior mutual company actuaries could agree on anything. Those of you who have worked with this accounting issue for mutual companies know we have historically had an awful time. We all agreed that GAAP as it was defined originally in the late 1960s and early 1970s didn't work for par business, but we could get no agreement on what should work. Here is a large, diverse group of major mutual life insurance company actuaries who say that this is the best standard for management reporting. That is phenomenal. There are many important considerations dealt with by that committee. If you haven't read that report which was distributed by the Financial Reporting Section, I would urge you to read it.

And finally, while not a conclusion, I think the computer model which M&R developed was tremendously effective in selling the members of the Task Force on what really happens between the blocks of business in a company, its total assets, its capital structure, and how it is affected by changes in dividend scale. The fact that this was a realistic model, which had a very representative dividend scale, and which indeed performed in accordance with a capital theory, was very critical in attaining an understanding of how these things hold together.

We obtained much increased knowledge of the role of capital in a life insurance company. The prime theoretical vision of any kind of mutual company is that a group of people get together, pool their resources, share the experience that emerges, and thus obtain the desired service at cost. This model or concept is at the heart of the mutual life insurance company philosophy, but the role of capital in that process has never been clearly understood. Given current practices, it's easy to see that a block of business requires outside capital at the time it starts up. It does not generate enough cash to provide the assets necessary to meet initial expenses, statutory reserve requirements, and provide the statutory surplus that the company needs. Where that capital comes from, and how it should be related to the operation of the blocks of business has not been made very clear in prior analyses. The model work and other exercises engaged in by the Task Force enabled it to understand that there is a direct relationship between the capital needs of individual segments of the business and the capital needs of the company as a whole, and that there is an appropriate means of determining the cost of capital that needs to be charged to policyholders in order to accomplish the company's goals. Since it is absolutely necessary for the company to maintain sufficient capital to continue its business, it becomes obvious that the cost of capital is an element in the cost which mutual policyholders must bear. Through the model and through separate exercises, it has been demonstrated that the cost of capital is directly a function of the required growth rate of the company, less the net investment earnings on the underlying funds related to the capital. An extremely significant relationship was verified through use of the model that a viable block of par business can have greatly varying dividend patterns, but the one single requirement which must be present is that the return on capital invested in the product must be adequate to sustain the growth of the company. So, in the specific model used by the Task Force, which had a fixed rate of growth, and a fixed rate of return, you could demonstrate that blocks of business could sustain the company with differing dividend scales so long as the change in capital needs and the appropriate cost was reflected in the dividend scales.

A disappointment to me in the Task Force report was the failure to emphasize the appropriate cost nature of surplus contributions. It is mentioned, but it just doesn't hit hard enough from my viewpoint. In particular, the use of contributions to surplus as the recommended method of allocating the payment to policyholders for membership rights emphasizes this particular cost to the exclusion of all others. The Task Force did sufficient work with respect to what has been described as the "revolving fund method" of operation in a mutual company to demonstrate that a company could theoretically operate with no entity capital. In that case, the overall fund available to pay policyholders when valued at the corporation growth rate would produce no value available for payment to policyholders for membership rights. If the particular definition of a revolving fund described in the Task Force report were in use, each generation would have a calculated zero amount payment to policyholders, since by definition the current value of past and future contributions to surplus is zero for each group. Thus a recommendation of this particular means for allocating payments to policyholders unfortunately implied that this particular method was superior from a conceptual viewpoint. In fact, it is very weak in that respect in that it chooses one particular cost -- the cost of capital -- as being the prime criterion for distributing payments to policyholders. I would much prefer some broader criterion such as total cost, than to emphasize the amount of capital used by contracts as the method for distribution of payments.

Finally I have some comments on the process itself. This was really an exciting thing. It was initiated by people who recognized that the inadequate understanding of the capital structure of mutual life insurance companies was a major stumbling block to understanding and devising appropriate conversion legislation and the carrying out of a successful conversion plan. It was remarkable that there were a large number of senior actuaries from mutual companies who met very regularly and who competed vigorously in an intellectual manner as to the approaches and techniques which might disclose to us the way things really worked in a mutual company. For those who participated, it was an exciting, rewarding experience. I would like to give particular recognition to Harry Garber's contribution. As Chairman, he worked exceedingly hard himself in this project, but he also encouraged the participation of any who were interested, and listened patiently to many points of view with which he disagreed, and in the end had a report which was bought by the whole group. This is an amazing accomplishment. The work of the Task Force had many tenets to it and the subcommittees themselves were exhausting and extensive in the scope of the work undertaken. Harry participated personally in almost all of these and gave a balanced leadership which enabled the whole thing to come off. The actuarial profession and the industry are indeed in debt to his leadership. I'd simply like to close with expressing my own personal appreciation for being able to participate in this activity. It was certainly a very rewarding experience for me.

MR. WILLIAM J. TAYLOR: Something which may not come through as clearly as it might is the connection between the amount to be distributed to policyholders and the concept of the market determining the value of that distributed amount. The identification of the problem of the three parties having to be satisfied in order to have a conversion, is a very vital aspect of this approach. It is the thing which makes it work. Having the market value determine the value to be distributed is a key aspect of that concept. In the discussion it was not clear how we got from the assets accumulated by existing policyholders and the amount to be distributed and the market value concept. Can anybody clarify that?

MR. GARBER: We started by trying to connect them very closely. In the first interim report we were using the assets accumulated by policyholders as appropriate compensation. The more we worked, the more we found that the key was, in effect, a market value of those accumulations. Whatever the company has accumulated on an asset basis or on a statutory value basis, has to be converted to market worth in order to make this thing work. What you have accumulated may be worth nothing at all, as some of the thrifts have found out, or may be worth a lot as it was in the Union Mutual case. It all depends on what kind of company you have when you get through with the process, or when you enter into the process. We eventually just cut the tie, realizing that the process of determining what the company needs in the way of capital, and what the market will accept and pay, and what the policyholders get, will reveal the common ground which then can be allocated by actuarial means. In itself, the process of determining the aggregate amount of policyholder compensation is not an actuarial determination. I think we were unsatisfied with that as actuaries, but when you try and use actuarial values given the ebb and flow of markets, you find they are not satisfactory for a public market situation.

MR. TAYLOR: Can I conclude then that you have eliminated entirely any values to be determined in advance of the market's determining of the value or do you still have the mixture?

OPEN FORUM

MR. GARBER: When you go into a conversion process, you will go in with a set of values you intend to give to policyholders. In so doing you will have worked with your investment banker to determine an aggregate value (and divided up that value) which you believe will permit the company's stock to sell in the market at a particular price. The value is established based on your estimate of the general nature of the effect of the market on the compensation relationships. This will change, of course, as markets change during the process. The whole conversion plan may get thrown out if the market goes way up or down. Your original plan, however, recognizes where your investment banker advisors believe the market would require you to be at that time.

MR. SHUR: It is true that for any particular amount of capital that is raised, and any particular market value of the company, there is an appropriate amount of compensation to give to policyholders. For a different amount of capital raised, there would be a different amount of compensation. There is a range involved. If you try to raise more capital than the top of the range, it just can't be done. If you give compensation in the form of stock to policyholders it is clear that the market value of all the company's stock will be equal to the market value of the stock from the new investors plus the market value of the stock given to policyholders. That is clearly a market value relationship -- not an actuarial relationship.

MR. TAYLOR: That's what I was getting to. Specifically, rather than having compensation to policyholders be defined in dollar amounts in any way, shape, or form, have it be defined in terms of shares. You then have a total number of shares to be distributed to policyholders, along with some method of determining how the shares are to be distributed among the policyholders. When you have the conversion, and the market value is determined by the marketplace, then the policyholders would know what they would be getting in the event that they wanted to cash out rather than take their value all in stock.

MR. GARBER: I think there are two ways you can do that. First, you can issue shares. Second, a company can tell policyholders what their dollar amount is, and what you think the conversion into shares will be, but the actual conversion into shares will depend on the final price. That's the way Union Mutual went. The New York proposed law specifies an actuarial and accounting calculation to determine the aggregate amount, which is the safe harbor amount.

Using the second approach assures the aggregate compensation to policyholders would equal the desired level; the first approach does not carry that assurance.

MR. MCCARTHY: It is instructive in that regard to take the facts and the numbers of the Union Mutual conversion and apply them to the formulas in the report. You will find they help you get an understanding of what those formulas are saying in terms of the particular dynamics of one conversion.

MR. DALE S. HAGSTROM: I want to emphasize that all of this work was done within the United States legal tradition. There is a very distinct and different tradition for Canada.

I also had two thoughts about the work. The Task Force reasonably concentrated on individual life insurance. However, if a company is demutualized, it will eventually have to deal with the fact that there are things that are allied with individual life insurance, such as individual annuities and perhaps individual health, which might well need to be in the closed branch, but are rather distinct in terms of their risks. If you go to demutualize you will start thinking about the practicalities. Are those in the same closed branch? In setting the closed branch initial assets, if one is a very volatile risk, say an investment risk for individual annuities, and you don't see the same risk exposure in individual life, you must ask how much risk you want to expose the individual life folks to if you fund individual annuity people on the "same basis." You might recognize that the C3 risk and C1 risk are much more important on individual annuities than they are for individual life when you are thinking about what initial closed branch assets you should have.

A second thought I have concerns the equity share, the amount you give upon demutualization. The linked method which the Task Force was inclined to recommend, takes the assets that have accumulated, either past or future, on today's inforce. If you had a defunct line of business with great losses not attributable to today's inforce, it might be reasonable to reduce the amount you give out in light of that historical fact. Obviously, if the market won't buy the stock otherwise, you may be forced to do so.

MR. GARBER: To the extent the losses were charged through the dividend formula to other lines, they would be reflected appropriately. To the extent they were not charged to other lines or recognized in the pricing of products in those other lines, then they wouldn't be reflected. We left it at that. Whatever the company had done in the past ought to be carried through.

MR. DONALD D. CODY: I want to express great admiration for this report. I would recommend that as a basic structure for all kinds of other examinations, not only of mutual companies, but also companies that issue nonguaranteed element products. The structure that you set up is good enough and trustworthy enough to serve as a basis for analysis of pricing and internal management financials. This is with respect to your general theory. I want to make a comment about the accounting report, too. I think it is unfortunate if you don't publish that in the *Transactions*, too. The two works ought to be together for the reasons I am giving.

One other comment. How do you expect this report to be used in regulation and laws? Are there actions underway in a variety of states to change the laws so that when they are needed they are available?

MR. GARBER: There is a specific bill in New York which was being written at an early stage of the Task Force work. Some of us participated in its development, although with probably only 20% of the knowledge we had when we finished the report. First, New York has multiple methods, which is one of the things we are recommending. Second, the method that does permit conversion with an immediate public market offering specifies an amount. This amount is bigger than statutory surplus, but less than GAAP book value, and could be characterized as a safe harbor. Safe harbor amounts are largely judgmental.

There is a lot of work going on by an NAIC Committee, which is headed by Terry Lennon of the New York Insurance Department, to draft a model bill which would be modeled on the New York bill. It will be a better, cleaner version, but with the same essential conversion methodologies that are in the proposed bill before the New York legislature.

MR. SHUR: You need at least one way to demutualize without a specific formula. There may be a company that is somewhat troubled and for which it is very important to have a demutualization, and that is the very one that is going to be thwarted by some specific defined amount to be given to policyholders.

So, in addition to safe harbors, there has to be at least one sort of a free method for which the insurance department can look at the overall situation and still be able to permit the conversion.

MR. GARBER: Built into the New York bill also is what we have characterized as the two-step method, where the first step is just to pass the entire ownership of the company to policyholders by giving them all shares, and then as a second step, at some later time, introduce a public market element. If your market value is very low relative to your book value, that approach would be one which would deliver market value appropriately.

MR. WILLIAM R. BRITTON, JR.: First of all, let me say that I agree with the emphasis in the report on the amount to be distributed to policyholders as being the critical question in conversions and demutualizations. This seems to be the most contentious issue with the regulators, who raise the most questions. I also concur that market values should be the basis that one uses. Where I was disappointed in the report, from a professional standpoint, was in its lack of forceful statement to the effect that we as actuaries have the best ability to give an estimate of a company's market value. This estimate is needed before conversion, if it is to be a Union Mutual situation. Or, there may be situations in which one could have a conversion and simultaneous acquisition where there never is a public market established, at least initially. I think the report is lacking in guidance to actuaries, but more importantly, in not establishing our role. One of the things I found in dealing with conversions, is that all of the other respective professions, investment bankers, lawyers, and accountants, looked to actuaries as having the best knowledge.

MR. MCCARTHY: I don't think the report is in contradiction to what you are saying. The report focuses on market value and, as brought out in the dialogue with Bill Taylor, you have to get some estimates of that ahead of time. Now the report wasn't intended to be a treatise on how to determine a market value. Certainly, actuarial valuation techniques are widely used in establishing ranges of buy/sell prices for companies. I would view that as an issue aside from the focus of the report rather than to say that the report somehow suggested otherwise.

MR. SHUR: We perhaps gave that impression by bending over backwards so as not to suggest there was some definitive actuarial value that should be given. When it occurred to us that such is not the case at all, we wanted to be sure we made that point very, very clear. You can do all the actuarial work you want in valuing the company, but the current state of the stock market may have more to do with the value of that company than all of that actuarial work, if there's a public market.

MR. GARBER: An additional answer to your question is that the acquisition case was not the one that was on our plate most of the time we were working. By the time it came onto the plate, we were tired and wanted to finish up. So, we plead that we really didn't give much thought to it. We should have, but it came into our view late in the game and without our having the energy to look forcefully at it. I think you are perfectly right. There is a lot of that in here. As we get more and more into individual company situations, trying to look at particular classes of business and so on, it is clear that the report sketched out some general ways of proceeding. There is much work left to be done for actuaries to fine-tune all of these things as they go into actual cases.

MR. TAYLOR: I have one other practical concern, for something that is not going to occur for many years, having to do with the closed branch. Looking out to the future, where that closed branch is tapering off and getting to be much smaller in size, it is obvious that one can do a lot better job dividendwise for that group of policyholders by not running its own portfolio of assets, etc., but rather by having some arrangement with the corporation as a whole for an adequate investment return on its assets. Was there any consideration given to that?

MR. MCCARTHY: We did recognize that there will come a point at which it might be useful, from an investment point of view, for the closed branch to own shares of assets rather than entire distinct assets. It is cleaner at the outset to start with distinct assets if you can, but there might be some situations in which you wouldn't even want to do that. You are talking about questions that are probably 50 or more years out. Perhaps we lack the foresight to see exactly how one of these things will wind down in the end. There are going to have to be some issues raised that are best done in the context of that situation.

MR. GARBER: We did try to study actual experiences of closed branch runouts, but we weren't able to find a great deal to help us. If we had some experience to rely on, we might have had some more sage comments to include in the report.

MR. TAYLOR: My concern was primarily of trying to assure that we don't get legislation that ties our hands on these matters that are not really going to develop for a number of years.

MR. SHUR: Hopefully, by the time that happens, the closed branch will be such a small part of the company that almost any reasonable approach will be acceptable for the handful of remaining policyholders.

MR. GARBER: You have to remember that you have crossovers anyway. Clearly, to the extent the closed branch was inadequate to pay guaranteed benefits, the company would have to stand behind those. My recollection of the New York bill is that it does not specify the allocation of assets to such a degree that it would be a problem.

MR. SHUR: I don't think it does. It says you need to put in assets that are sufficient to do these things and it doesn't strictly say which assets.

MR. GARBER: Yes, I think taking pieces of assets would be a perfectly satisfactory approach.

MR. CODY: Can you say anything about the possibility of a tontine effect?

MR. GARBER: We said the actuary's task would be to try to make it as little as possible. Obviously, if you decline from 20 policyholders to 1 in one year, there could very well be some tontining.

MR. CODY: You wouldn't want the law to require a tontine, however.

MR. GARBER: Literally, I think that is what it requires.

MR. SHUR: Once the asset goes into the closed branch, it cannot come out and no earnings on it can come out.

MR. CODY: Do you think the actuary is clever enough to avoid this?

MR. GARBER: No! What we think is that when the branch becomes very small, the actuary will err on the side of overdistributing. It will be an immaterial event for the company to pick up the costs of the last policyholder. As a practical matter, a company would rather do that than leave a million dollars for the last policyholder.

MR. MCCARTHY: There are probably some things you would do, either within the rest of the company or outside, by way of reinsuring as the closed branch gets quite small to establish a clear line to the end.

MR. MICHAEL E. MATEJA: Our company has a small participating department, and the treatment of that department bears directly on the investment question that was just raised. Perhaps 20 years ago there was great concern about the relative treatment of the participating versus the nonparticipating department from a standpoint of investment performance. A very elaborate procedure was developed to assure that the management of the company could never be accused of discriminating unfairly against the participating policyholders. Basically, what it did was go to the cash drawer -- the par cash drawer and the nonpar cash drawer -- each time we were going to buy an asset. If there was 10% of the assets in one drawer and 90% in the other, they shared in that proportion and that process has been followed pretty much inviolately for many, many years. You get the benefit of the diversification. You get some of the good high-yielding deals as well as some lower yielding deals.

MR. SHUR: Is that still an open branch, Mike?

MR. MATEJA: Yes, it is.

MR. MCCARTHY: In managing a closed branch, where your long-term objective is dividend stability, it's not clear that the assets you are acquiring for the corporate entity in total ought logically to be split that way. You might have very different investment objectives for the closed branch than the rest of the company. You need to think about that as you go along. Particularly, I think that's a difference between an open and a closed branch. Your perspective will change in a closed branch.

MR. SHUR: I would like to suggest that you look at the results of the model separate and apart from demutualization. Here is a normal company that has grown up over 75 years, with many tables describing everything that has happened with that company, including the fact that it has about $116 million dollars in statutory surplus. The terminated policies have raised something like $200 million, so a lot more than the statutory surplus has come from terminated policies. A lot of interesting bits of information are in that model.

MR. GARBER: On the particular point about the three different methods of allocating assets between terminated and inforce policies, the Task Force didn't take a position on which was the better method. It seemed they are all approaches that one could use, although we recognized that an insurance department is likely to buy Approach 1 faster than 2 or 3. They have, from our point of view, equal theoretical justification.

MR. RAMSEY: It is all well and good to say you can have a model company in existence that will sustain itself if the company follows the capital charge process that we have described. But how does a mutual company get its initial capital? One of the interesting things we did was to look through our own companies' histories. In the early years, policyholders paid pretty high premiums and companies didn't hold much in the way of reserves nor did they pay much in the way of commissions or administrative expense. If there were a few more deaths in those years, there would be fewer companies today. It appears clear that policyholders paid high premiums and really made "contributions to surplus"; i.e., they left money in the company that wasn't necessary to cover current policyholder costs. Early policyholders really did contribute. Most of the big old companies started in the mid-1800s and had 50 years of experience by the time they got to 1900. In 1900 their size was pretty small in relation to the size of the company today. Almost all have had a 4% to 7% annual rate of growth since 1900; thus if they had enough entity capital in 1900, capital charges to policyholders of the type described would appear to have resulted in quite nominal capital charges over that period for the companies.

REPORT OF THE TASK FORCE ON MUTUAL LIFE INSURANCE COMPANY CONVERSION*

I. INTRODUCTION

This Report presents the results of a three-year study by a Task Force of the Society of Actuaries. The charge to the Task Force was "To examine the actuarial issues involved in converting a mutual life insurance company to a stock form of ownership, and to produce a record of its examination." In order to accomplish its assigned task, the Task Force found it necessary to consider the conversion process in a broad way and not to limit the scope of its analyses to strictly actuarial issues.

Early in its work, the Task Force recognized that a conversion is a voluntary action by a company, the terms of which must be approved, explicitly or implicitly, by the other interested parties, namely, the participating policyholders and, if equity capital is being raised in the public market or the company is being acquired, the new investors. In summary, these conditions are the following:

- The company will undertake the conversion only if it can achieve the structural and organizational objectives it seeks, one of which frequently will be the raising of adequate new capital;
- participating policyholders are satisfied that the converted company will be operated in a manner that will not impair and, if possible, will enhance its ability to meet its contractual obligations, the conversion action will not materially affect their policy dividends, and they will receive fair value for the cancellation of their membership rights; and
- the investors are satisfied that the company will offer a market rate of return on their investment, through shareholder dividends and stock appreciation.

The work of the Task Force concentrated on three principal aspects of a mutual life insurance company conversion:

1. maintenance of reasonable policyholder dividend expectations,
2. the aggregate amount of compensation to policyholders in exchange for their membership rights, and
3. the allocation of this aggregate amount of compensation among participating policyholders.

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The principal findings in these three areas are summarized in the subsections below.

Maintenance of Reasonable Policyholder Dividend Expectations

The Task Force recommends that the maintenance of reasonable policyholder dividend expectations be achieved by establishing a closed accounting branch for dividend purposes. The assets initially allocated to this closed branch would be in an amount which, together with future premiums, would be sufficient to pay the (then) current scale of dividends if the (then) current experience continued. The closed branch would be dedicated to policyholders; none of the funds would ever revert to shareholders. The Task Force believes that a closed branch is appropriate for most individual coverages, and its establishment would facilitate the acceptance of conversion plans.

Aggregate Amount of Compensation to Policyholders in Exchange for the Cancellation of Their Membership Rights

The Task Force reached two very important conclusions concerning the aggregate amount of compensation to policyholders in exchange for the cancellation of their membership rights:

1. The Task Force believes that no accepted and recognized actuarial or scientific basis for the determination of aggregate compensation to policyholders for the cancellation of their membership rights has been established, either in the ongoing financial operations of mutual life insurance companies or by previous conversions and liquidations of mutual life insurance companies.
2. Furthermore, as a result of its work, the Task Force has come to believe that it would be very difficult, if not impossible, to develop an actuarial or scientific basis for the determination of aggregate compensation to policyholders which could be accepted and recognized at this time. It is clear that, regardless of the form of conversion, the real value of the aggregate compensation to policyholders will depend to a significant degree on the converted company's market value (that is, the assessment of the company's worth by outside investors). There is no recognized and accepted actuarial or scientific basis for the determination of market values and, even if there were, the results would depend to a large degree on specific company circumstances and could not be generalized.

The Task Force analyzed the relationship between the aggregate amount of compensation available to policyholders and a variety of different company and market circumstances, and different (including zero) capital raising objectives. We were struck by the wide range of results possible for the value of the aggregate compensation to policyholders under these different conditions. In these circumstances, the Task Force believes that it is inappropriate for a demutualization statute to establish a fixed or formula amount of compensation to policyholders. Rather, we suggest that such a statute contain separate provisions for the various types of conversions and, where the conversion involves a concurrent public offering, the statute should provide a safe harbor amount which would assure a converting company that it could proceed if the aggregate compensation to policyholders equaled or exceeded that value. In addition, there should be provision for regulatory review where the proposed aggregate compensation to policyholders is less than the safe harbor amount, to permit conversions which may, nevertheless, be in the best interests of all the interested parties.

Allocation of Aggregate Amount of Compensation Among Participating Policyholders

The Task Force recommends that such an allocation be based primarily on the relative contributions of policyholders to the surplus of the company. It further recommends that the measure of policyholder contributions to surplus be taken as the assets accumulated by such policyholders, less the amounts required to be placed in the closed branch on their behalf. This is a new measure developed by the Task Force which we believe is most appropriate for this purpose.

In order to provide a sound theoretical basis for some of its conclusions, the Task Force developed a computer model of a mutual company's financial operations. Appendix 1 presents the assumptions underlying the development of the model together with some results from its operation.

Through the use of the model, together with an examination of the financial operations of the mutual companies represented on the Task Force, we concluded that most mutual companies use an entity capital financial management approach (under which classes of policyholders make permanent contributions to the capital of the company). We believe that this approach is superior to the revolving fund approach (under which classes of policyholders do not make permanent contributions to capital). Our work in this area is summarized in Appendix 2.

II. BACKGROUND

This is the report of the Society of Actuaries Task Force on Mutual Life Insurance Company Conversion. The Task Force was appointed in July 1984 with the following charge: "To examine the actuarial issues involved in converting a mutual life insurance company to a stock form of ownership, and to produce a record of its examination."

The subject has proven to be exceedingly interesting and demanding. Over a period of more than two years, the Task Force met monthly and established committees that met between meetings of the full Task Force.

There have been relatively few conversions of mutual insurance companies, and most of them have been conversions of property and casualty companies. The life company conversions completed before the Task Force came into being involved relatively small companies and/or immediate acquisition by another company, so that many of the issues a large multiline mutual company would encounter in a conversion to an independent stock company were new. The Union Mutual conversion occurred during the lifetime of the Task Force. Many of the concepts reflected in that conversion and many of the practical problems encountered in its implementation have been helpful to the Task Force in the development of this report.

The law, in most of the states that have any law on this subject, is the same as or has been derived from the law applicable to conversions of property and casualty companies, and is rudimentary in form. Furthermore, the overall theory of mutual company financial operations has been the subject of only two papers in the Society's *Transactions*,[1] with, as evidenced by the discussions, considerable divergence of views among actuaries. In these circumstances, the Task Force undertook this work with little guidance and limited precedents, and much of the work has been in the nature of a learning process for the Task Force members.

An interim report was issued in August, 1985. Our work since then has confirmed and extended most of the preliminary conclusions of the interim report. This report is complete; no reference to earlier reports is required.

The Task Force was asked in its letter of appointment to have its "proceedings be perceived as being as open as possible." Toward this end we have sought breadth in the membership of the Task Force; we have established committees with members who are not on the Task Force; we have invited interested actuaries to attend our meetings; and we held open committee meetings during the Society's 1985 and 1986 annual meetings.

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[1] Leckie, Robin B. "Some Actuarial Considerations for Mutual Companies," *TSA*, XXXI (1979):187–259.
Trowbridge, Charles L. "Theory of Surplus in a Mutual Insurance Organization," *TSA*, XIX (1967):216–266.

III. BROAD CONCEPTS AND CONSIDERATIONS IN THE CONVERSION PROCESS

The Task Force started without a prescribed agenda and its first task was to identify the essential issues.[2]

In the identification of issues to be studied and in the subsequent examinations of these issues, the Task Force recognized that companies wishing to convert may be in different circumstances and that conversions might take one of several forms. The Task Force considered three conversion forms:

1. a conversion in which there is an initial public offering (of common stock) as a part of the conversion action,
2. a conversion in which the converted company is acquired immediately by another company, and
3. a conversion in which no new capital is raised in the conversion action and the converting company is not acquired.

This latter form includes so-called two-step conversions in which the conversion and a subsequent action to raise equity capital through a public offering are distinct and separate actions. Because conversions involving initial public offerings of common stock involve the full range of issues, we concentrated most of our attention on this form. Most of our analyses and recommendations are general, however, and are applicable to all three forms. If this is not the case, the text will identify the nature of the differences.

Regardless of the form of conversion, the Task Force recognized that a conversion is a voluntary action (on the part of the converting mutual company) which must be approved explicitly or implicitly by the other groups that are parties to the action: the participating policyholders and, in the case of a conversion that involves raising additional equity capital or acquisition by another company, the new, nonpolicyholder investor(s). Given that the process must involve the voluntary consent (meeting of the minds) of these interested parties, the Task Force sought to identify the relevant questions through an examination of the interests and reasonable expectations of the several parties to a conversion action.

Interests and Expectations of Interested Parties

The primary interest of the company is its long-term growth and survival.

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[2] In keeping with the charge to the Task Force, our concentration has been on actuarial issues. In certain cases (particularly the issue of the aggregate amount to be allowed to policyholders for cancellation of their membership rights), our inquiry and observations have extended somewhat beyond the boundaries of actuarial science. We recognize that these are extensions of our charge, but we believe they are necessary if we are to obtain and convey a full understanding of this subject.

A necessary condition is that the company be able to generate and retain sufficient capital to permit it to enter, to expand and to compete in its selected markets, and to maintain, securely, its ability to meet its obligations to policyholders. If the management and directors of a company conclude that its continuation as a mutual company will not permit the generation and retention of sufficient equity capital to assure safety of financial operations, competitive pricing and its future growth and development, a conversion should be considered. A conversion action, one of whose principal purposes is to gain access to the equity capital markets, will be undertaken only if the company believes that it will be able

- to have a successful common stock offering at the time of the conversion action or at another time of its choosing,
- to establish a public market in its stock, and
- to obtain corporate structure flexibility (through the formation of an upstream non-insurance holding company) and other advantages of a conversion action.

A company that did not contemplate the need to access the equity capital markets in the near term might undertake a conversion action if it were able to achieve structural flexibility through such an action. In the case of a company whose conversion strategy depends on its acquisition by another entity, the key question is whether the applicable conversion law and regulatory processes will permit it to be acquired on terms that will be attractive to the entity company and satisfactory to its participating policyholders.

Current participating policyholders have two types of interests and expectations. The first concerns their insurance coverages. The expectation here is that the converted company will be operated in a manner that will not impair and, if possible, will enhance its ability to meet its contractual obligations and that the conversion action will not adversely affect policy dividends provided under their participating policies. The second type of interest and expectation of participating policyholders concerns their membership rights. The expectation of policyholders is that in any conversion action they would receive fair value for the cancellation of these membership rights.[3]

In conversions in which equity capital is raised at the time of or after the conversion, a third interested group consists of investors who purchase stock. Because these investors are seeking a good return on their investment in the converted company and there are numerous other investment opportunities available, these investors will have no interest in purchasing the equity of a converted company unless they believe that the company will offer a market rate of return on the investment (through shareholder dividends and appreciation). For purposes of this analysis an acquiring company can be considered as an investor, though one with both a greater interest in and a greater ability to control the return on its investment.

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[3] Membership rights include, principally, the rights to receive dividends, to elect directors and to receive the net value of the company in the event of its liquidation. The cancellation of these rights in a conversion action does not, however, cancel the participating policyholders' contract rights to receive dividends.

In summary, a conversion action involving an initial public offering of common stock will be possible and successful only if the reasonable expectations of the three interested groups are met. These expectations are that

- the company believes it will be able to gain access to the equity capital it requires and it will obtain its other conversion goals,
- policyholders believe their guaranteed benefits will be met, the converted company will maintain their reasonable dividend expectations and they will receive fair value for cancellation of their membership rights, and
- investors believe they will receive a market rate of return on their investment.

Three conditions must exist if these expectations are to be met. These are that

1. the earnings record and prospects of the company and the general capital market conditions permit it to achieve its capital-raising goals;
2. the particulars of the conversion plan reasonably satisfy the policyholders' objectives;
3. the applicable demutualization laws, regulations and methodologies permit the reasonable expectations of all three of the interested parties to be met.

The third condition is particularly important; if it is not satisfied, these laws, regulations and methodologies will thwart the result that they were intended to permit, a successful conversion.

Specific Issues Studied by Task Force

The Task Force concluded that its scope should be broad. Accordingly, we have sought to have our analyses, insights, observations and conclusions applicable to all salient elements of the conversion process, from the design of demutualization laws and regulations to the development of company conversion plans. Given the great breadth of subject material, the Task Force found that it could not address both the development of theory, concepts and principles and the details of the many actuarial practice activities identified in our study. We chose to concentrate on the former.

As to the specific issues, the Task Force concluded that it should focus on three major topics. The first concerns the actuarial aspects involved in assuring that the reasonable dividend expectations of participating policyholders will be met by the converted company. This subject is discussed in Section IV. The second topic concerns the issues involved in establishing the aggregate amount of consideration to be awarded to policyholders in the conversion action in exchange for cancellation of their membership rights. This topic is discussed in Section V. The final topic on which the Task Force focused concerns the analytical techniques and methods of allocating the aggregate amount of consideration among the eligible policyholders. This topic is covered in Section VI.

The Task Force also considered two other topics: conversion accounting and demutualization experience outside the United States. These topics are discussed briefly at the end of the report.

The Task Force spent a considerable amount of time and effort constructing a computer model of mutual company financial operations for use in its study of conversion methodologies and selecting and analyzing an appropriate conceptual model of mutual company financial operations. This work is described briefly in the next two subsections and more extensively in the related appendices.

Model of Mutual Company Financial Operations

Early in its work, the Task Force concluded that it was essential to develop a computer model to enable it to better understand certain aspects of mutual life company financial operations and to test various hypotheses concerning the conversion process. A report describing the model and presenting some of its results was issued in 1986 under the title "Interim Report to Task Force on Mutual Life Insurance Company Conversion from its Individual Life and Annuity Subcommittee." A copy of this report with such formatting and other changes as were required to make it an appendix of this report is attached as Appendix 1.

Mutual Company Capital Management

At an early stage in its study of mutual life insurance company conversion, the Task Force decided to analyze the financial management principles and practices used by mutual companies and to focus, in particular, on the principles employed in the management of a mutual company's capital structure. Our purpose was to identify, if possible, a model of mutual company financial operations that could be used as a base in our consideration of the several subjects covered in this report, including the provision for post-conversion dividends on participating policies and the compensation to participating policyholders for cancellation of their membership rights (in the aggregate and individually). The two principal models considered were the entity capital model (in which the classes of participating policyholders make permanent contributions to the capital of the company) and the revolving fund model (in which classes of participating policyholders do not make permanent contributions to capital). We selected the entity capital model as the capital management model that best characterizes the financial operations of the companies with which the members of the Task Force were associated and, we believe, most other mutual companies as well. Both of these capital approaches are described and compared in Appendix 2. In addition, this appendix presents some implications of the entity capital approach in the conversion process. The most important of these implications for purposes of this report are the following:

- The term, "maintenance of reasonable policyholder dividend expectations," can clearly be defined as payment of the current dividend scale (including terminal dividends) if current experience continues.
- The accumulated capital of the company at the time of conversion will have been contributed, in part, by in-force participating policyholders and, in part, by other policyholders (that is, participating policyholders whose policies are no longer in force and nonparticipating policyholders, in force and terminated).
- Any valuable consideration given to members in a conversion action as compensation for cancellation of their membership rights has no counterpart in the ongoing financial operations of a mutual company, and there is no recognized basis in precedent, experience or membership expectations for the determination of such valuable consideration.

IV. ACTUARIAL ISSUES RELATING TO THE MAINTENANCE OF POLICY GUARANTEES AND REASONABLE POLICYHOLDER DIVIDEND EXPECTATIONS

The Task Force believes that the conversion action should not reduce the ability of the company to meet policy guarantees nor should it materially impair the ability of the company to meet the reasonable dividend expectations of policyholders with participating contracts. The reasons are both theoretical and practical. By providing access to the equity capital markets, conversion should serve, at least potentially, to strengthen the company financially. Similarly, the conversion plan should be designed to provide assurance that the policyholders' reasonable dividend expectations (that is, the continuation of the current dividend scale if current experience continues) will be met. If the conversion plan is deficient in this respect, policyholders will be required, in voting on the plan, to weigh the benefit of the compensation offered for the cancellation of their membership rights against the potential of reduced dividends. As a practical matter, therefore, a mechanism that will provide assurance of meeting policyholders' reasonable dividend expectations will probably be a minimum requirement both for regulatory approval of a conversion plan and for obtaining the approval of members.

The Task Force considered several mechanisms to help assure policyholder guarantees and dividend expectations. Three methods seem to have merit:

1. The establishment of a closed branch for specified groups of participating policies and the allocation to this closed branch of sufficient assets to assure payment of the current scale of dividends (in addition to the contractual guarantees) if current experience continues. These assets would be committed to providing benefits and dividends to policies included in the branch. One closed branch could be established for all classes of business or separate closed branches could be established for different classes.

   In general, no new policies would be written in a closed branch after conversion, although some additions might be required to satisfy existing contractual obligations.
2. A second method would be to establish branches similar in form and operations to the participating branches of stock companies. If the converting mutual company were to follow this method, the amount of assets placed initially in such a branch would have to be sufficient not only to maintain dividend expectations and contractual obligations, but also to permit the company to withdraw a portion of the predividend earnings of the branch in accordance with a formula specified in the conversion plan.
3. A third method would be to continue to operate the business without setting up a separate branch and to rely on competition and internally established accounting techniques to achieve fair dividend treatment.

The Task Force believes that the third method is probably the most appropriate one for insurance and pension coverages sold to corporate customers, particularly large customers. These coverages tend to be continuing and individually experience rated, and competition will largely assure appropriate dividend treatment. For individual coverages, which by their nature involve a significant sharing of risks, a method that would clearly segregate experience seems to be required.

After considering the merits of the first two methods, the Task Force concluded that for individual policyholders the first method, the closed branch, appeared to be the most promising route and presented the most clear-cut formulation of actuarial questions and issues. The principal reasons are that the objective of the method is clearly defined and the method involves an allocation of assets necessary to meet that objective. We believe this method could be more easily understood and accepted by policyholders than a method in which profits are withdrawn from the participating policyholders' fund after conversion. The results of our examination of the closed branch method are described in the following paragraphs.

The closed branch is a mechanism designed to help assure the guaranteed benefits and reasonable dividend expectations of participating policyholders by setting aside in the closed branch sufficient assets for this purpose. As this mechanism may not be appropriate and effective for all lines of business, decisions must be made as to which particular classes of policies are to be included in the closed branch and which classes are to be excluded. To the extent that these decisions are not preempted or prescribed by statute, the following criteria might be used:

- If for a class of policies there is an expectation of substantial policy dividends and the company has significant discretion as to whether those dividends are paid and in what amounts, the class should probably be included in the closed branch.
- If the dividend structure for a class of policies is based more on broad averaging of costs than on policy-by-policy experience rating, the class should probably be included in the closed branch. Policies experience-rated largely on an individual basis should probably not be included in the closed branch.
- Classes of policies included in the closed branch should be expected to diminish in size with the passage of time and to eventually disappear. Any class of policies not expected to diminish over time is probably not suited for inclusion in the closed branch.

The application of these criteria to the several classes of business of a life insurance company is presented in Appendix 3.

The establishment of such a closed branch presents many new actuarial issues relating both to the establishment of the branch in the conversion action and to the ongoing operation of such a branch.

Among these issues are the following:

- What total amount of assets and which specific assets should be placed in the closed branch initially?
- What expense and other charges should be made to the closed branch as a part of its ongoing operations?
- What schedule of reviews of the financial position of the closed branch and adjustments of dividend scales will be necessary to assure that, on the one hand, the

branch retains sufficient funds to meet claim requirements and dividend levels consistent with emerging experience and that, on the other hand, the branch does not accumulate "excess" assets resulting in "tontine" dividend levels for long-term survivors of the closed branch?

- What new actuarial techniques might these reviews involve?

Appendix 4 presents and discusses these and the other issues that the Task Force has identified with respect to the establishment and maintenance of such a closed branch and, in the case of certain issues, presents the conclusions of the Task Force.

An important and somewhat related set of issues concerns the need for actuarial opinions and determinations required at the time of conversion with regard to the closed branch and the participating policies not included in the closed branch and, after conversion, with regard to subsequent determinations for the closed branch. The purpose and scope of such actuarial opinions will need to be specified and the appropriate actuarial organizations will need to develop applicable qualification standards, as well as principles and standards of practice, for individuals signing such actuarial opinions. This subject is also discussed in Appendix 4.

The Task Force did not have time to carry out a more detailed examination of a stock company type of participating branch approach. The exploration of the actuarial issues of such an approach would depend to an important extent on whether or not such a branch would be closed to new business and on the definition of profits to be withdrawn. For example, a branch to which no new business is added and which is expected to produce a specific stream of profits involves precisely the same actuarial issues as the closed branch. (The profit stream in this case is merely a stream of payments to be provided for in establishing the amount of assets required initially in the closed branch.)

V. POLICYHOLDERS' MEMBERSHIP VALUES — AGGREGATE AMOUNT

In addition to establishing a mechanism to help assure that contractual obligations and reasonable dividend expectations will be met, the conversion plan will likely provide that participating policyholders of a converting company receive equity shares of the converting company (or, in lieu of shares, substantially equivalent amounts of cash, additional insurance benefits or other considerations) as compensation for cancellation of their membership rights. The applicable conversion law will require such a provision in virtually every case. But even if not required by the conversion law, the Task

Force believes that compensation to existing policyholders for cancellation of their membership rights would be an integral part of virtually every successful conversion plan. This subject is considered and discussed in the remaining paragraphs in this section.

Because this subject is so fundamental to the conversions in which new equity capital is raised or the converted company is acquired, we studied it extensively and devote much of our report to it, even though our analyses demonstrated that it is not solely an actuarial issue. We believe that our analyses and observations contain insights that would be useful in the shaping of conversion laws and regulations and in the design of conversion plans.

The Task Force believes that the following six statements and their accompanying expansions and explanations bear, importantly, on the issue of aggregate policyholder compensation:

1. The capital of mutual life insurance companies has been generated primarily from amounts retained from participating policyholders. Under the entity capital approach, which the Task Force endorses, these "implicit or explicit" capital charges are permanent contributions.
2. At the time of conversion, the capital of a mutual life insurance company will have been contributed in part by participating policyholders whose coverage is then in force and in part by participating policyholders whose coverage is no longer in force or by nonparticipating policyholders. This is a clear consequence of the entity capital method of capital management.
3. The membership rights of participating policyholders in a mutual life insurance company include, principally, the right to receive policy dividends and the right to elect the company's directors. These rights are not identified with any specific ownership interest, in the aggregate or member by member.
4. In the unlikely event of the liquidation of a mutual life insurance company, state law typically requires the distribution of the net residue (after the satisfaction of all obligations) to participating policyholders. Task Force members do not know of any situations in which such a liquidation has occurred.
5. Policyholders in a mutual life insurance company would expect to receive guaranteed benefits and policy dividends; maturity or surrender of the contract would ordinarily bring no expected compensation for the simultaneous termination of membership rights (termination dividends would be considered as policy dividends for this purpose). Therefore, any valuable consideration given to members in a conversion action as compensation for cancellation of their membership rights has no counterpart in the ongoing operations of a company, and there is no recognized basis in precedent, experience or membership expectations for the determination of such valuable consideration.
6. A mutual life insurance company cannot, by definition, have a public market value before conversion.

It is clear that, before conversion, a mutual life insurance company has neither an established market value nor an accepted way of defining ownership interests. These values must necessarily emerge as a part of the conversion process itself, and as the analyses in this section demonstrate clearly, they are affected importantly by the company's circumstances and the general state of the public equity markets. They may also be affected, to some extent, by the form of the conversion. Our analysis is focused on conversions in which a public market is established, new shareholders acquire an ownership position in the company through the sale of equity, and participating policyholders acquire the remaining ownership interest (plus, perhaps, cash or other consideration) in exchange for cancellation of their membership rights. We took this approach because we believed that this form of conversion illustrated all of the relationships involved. Later in the section there is a discussion of the extent to which this analysis is applicable to the other forms of conversion.

Analysis of Conversions with Concurrent Initial Public Offering

In our analysis we sought to integrate the perspectives of the three interested parties to a conversion (the company, its participating policyholders and the new shareholders) and to answer the question, "What is the appropriate aggregate amount of compensation to participating policyholders in circumstances in which a conversion could be effected?" This question is most relevant because conversion is an action undertaken voluntarily by a mutual company and there will be no conversion (and no compensation to policyholders) if the requirements of the other interested parties are not also satisfied.

The interrelationships of the financial interests of the three parties that will exist at the time of a successful conversion action (other than the interest of policyholders in the protection of guaranteed policy rights and in a mechanism to help assure that their reasonable dividend expectations will be met) can be described mathematically in the following expression:

$$\text{Policyholders' equity value } (A) + \text{New shareholders' equity value } (B) = \text{Company's market value } (C). \qquad (1)$$

This is an obvious and necessary formulation in which

(A) is the market value of the shares awarded to policyholders in the conversion process for surrender of their membership rights (and excluding any amounts paid to policyholders in cash or additional benefits), (*B*) is the market value of the equity stock purchased by new shareholders (including any purchased by policyholders through exercise of preemptive rights), and

(*C*) is the total market equity value of the converted company (which is equal to the offering price of the common stock times the number of shares outstanding).

The following paragraphs discuss some of the interrelationships and implications of this expression.

The first important aspect of this expression is that it is based entirely on market values. To raise equity capital, the company must sell common stock in public markets. The prices at which such sales are made reflect not only the company's book value but, more importantly, the company's earnings record and trends, the market's view of the industry's prospects and the company's strategic positioning, the market's general price/earnings level, and so on. (The market valuation may be higher, lower or about the same as the company's book value.) Therefore, in fashioning its conversion plan the company will have to recognize the current general state of the stock markets, the likely evaluation of the company by these markets, the amount of equity capital which the company wishes to raise, and the amount to be awarded to policyholders in exchange for surrender of their membership rights.

The second key factor to recognize is that at the time of conversion the per share value of the stock purchased by new shareholders (including any policyholders who purchased stock on the same terms as the new shareholders) must equal the original issue price of the stock.

The third important aspect is to recognize that there is an interrelationship between the amount of new capital raised (the new shareholders' equity in the expression) and the company's market value. In fact, each dollar of new capital will increase the total market value of the converting company by an amount which depends principally on the market evaluation of the use to which the company will put the additional capital.

One further point on this subject. In a conversion action the market will make only one judgment (coincident with the new equity offering) and not two judgments (one before the equity offering and one after). In these circumstances, therefore, it is important to recognize that while the value of the equity shares awarded policyholders in a conversion action could depend on the amount of capital raised, the specific relationship cannot be determined. In particular, no valid conclusions can be drawn in a completed or prospective conversion action as to whether the amount of new equity capital raised diluted policyholder interests (and by how much) nor as to whether a larger (or smaller) amount would have had a materially different effect.

Note that this analysis excludes any provision for the initial public offering underwriting discount and for the conversion expenses, both of which will be sizable. In the following formulas and illustrations these omissions overstate the amount of equity available to policyholders and/or the amount of capital that could be raised. The Task Force does not believe, however, these omissions affect its conclusions to a material degree.

Given this general background, the Task Force explored the interrelationships among the factors involved, particularly the interrelationships between aggregate amount of compensation to policyholders, the amount of new capital raised and the market evaluation of the company. To do so, the Task Force defined the following terms:

Policyholder Compensation Ratio (*PCR*) = the ratio of the aggregate amount of policyholders' consideration (*PC*) to the preconversion GAAP book value (*PREBV*).[4]

New Capital Ratio (*NCR*) = the ratio of the net amount of new capital raised in the conversion (that is, new capital, *IPO*, less cash payments to policyholders, *PCC*) to the preconversion GAAP book value (*PREBV*).

Market Value Ratio (*MVR*) = the ratio of the postconversion market value (*POMV*) of the converted company to its GAAP postconversion book value (*POBV*).

Given these definitions, the terms in Expression 1, at the point of conversion, may be described as follows:

(*A*) Policyholders' equity value = *PC* − *PCC*

(*B*) New shareholders' equity value = *IPO*

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[4] In this analysis it is assumed that policyholder's compensation is received in the form of cash or equity shares and that no compensation is received in benefits or in another form.

$$(C)\ \text{Company's market value} = MVR\,(POBV) = MVR\,(PREBV + IPO - PCC).$$

Note that the postconversion GAAP book value is equal to the preconversion value plus the amount raised in the initial public offering less the policyholders' consideration amounts paid in cash.

Expression 1 may now be restated as follows:

$$(PC - PCC) + (IPO) = MVR\,(PREBV + IPO - PCC). \qquad (2)$$

Rearranging the terms results in the following expressions:

$$PC + (IPO - PCC) = MVR\,(PREBV) + MVR\,(IPO - PCC) \qquad (3)$$

and

$$PC + (IPO - PCC)\,(1 - MVR) = MVR\,(PREBV). \qquad (4)$$

If both sides of Expression 4 are divided by the amount of the pre-conversion book value (*PREBV*), the result is:

$$\frac{PC}{PREBV} + \left(\frac{IPO - PCC}{PREBV}\right)(1 - MVR) = MVR. \qquad (5)$$

Substituting appropriately the terms *PCR* and *NCR*, we have the following expressions:

$$PCR + NCR\,(1 - MVR) = MVR, \qquad (6)$$

or

$$PCR = MVR - NCR\,(1 - MVR). \qquad (7)$$

Note some observations about Expression 7:

1. If the Market Value Ratio (*MVR*) is greater than 100 percent (that is, the market value exceeds the GAAP book value), the right-hand expression will exceed 100 percent and the compensation to policyholders will exceed preconversion GAAP book value.
2. If *MVR* is equal to 100 percent, *PCR* will equal 100 percent (and the compensation to policyholders will equal preconversion GAAP book value).
3. If *MVR* is less than 100 percent, *PCR* will be less than 100 percent and the available compensation to policyholders will be less than preconversion GAAP book value. Furthermore, the available compensation will also be related to the amount of capital being raised. Some illustrative values for *PCR* are the following:

TABLE 1

POLICYHOLDER COMPENSATION RATIO (*PCR*)

MVR	*NCR* = 0%[5]	*NCR* = 25%	*NCR* = 50%	*NCR* = 75%	*NCR* = 100%
50%	50.0%	37.5%	25%	12.5%	0.0%
70	70.0	62.5	55	47.5	40.0
90	90.0	87.5	85	82.5	80.0

If the *PCR* for the converting company has been fixed by the applicable conversion law, the converting company needs to consider the impact that the state of the capital markets and the evaluation by the markets of its value and prospects might have on the amount of capital it can raise. To do this, we transform Expression 7 into a form in which *NCR* is the dependent variable and *PCR* and *MVR* are the independent variables. This expression is

$$NCR = \frac{MVR - PCR}{(1 - MVR)}. \qquad (8)$$

Note some observations about Expression 8:

1. If the Policyholder Compensation Ratio (*PCR*) equals or exceeds the Market Value Ratio (*MVR*), no new capital can be raised.
2. As the *MVR* approaches 100 percent, the New Capital Ratio (*NCR*) rises very rapidly. Some illustrative results for *NCR* are shown below:

TABLE 2

NEW CAPITAL RATIO (*NCR*)

MVR	*PCR* = 50%	*PCR* = 60%	*PCR* = 70%	*PCR* = 80%	*PCR* = 90%
90%	400%	300%	200%	100%	0%
70	67	33	0	0	0
50	0	0	0	0	0

Before presenting conclusions from these analyses, it is important to understand their nature and limitations. First, these formulas and results illustrate the relationships that must exist for a given set of conditions at the time a conversion takes place. As such, this approach can be quite helpful in illustrating and understanding the fundamental relationships involved, but it cannot be used, except in a general way, to reach conclusions about what the effects of particular courses of action might be. The reason is that in a dynamic world there are interrelationships among the factors. In particular,

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[5] Note that these are the market values of the compensation to policyholders when no new capital is raised.

MVR (the ratio of market value to book value after conversion) may depend importantly on the relative size of *NCR* (the net percentage increase in book capital resulting from the conversion and the initial public offering). Thus, in Table 1, it cannot be assumed that a company with an *MVR* of 70 percent, an *NCR* of 25 percent and a resulting *PCR* of 62.5 percent would have to reduce the *PCR* to 55 percent if it sought to double the increase in book capital (that is, *NCR* = 50 percent). Such an action would affect the *MVR*, and therefore, the resulting *PCR* value cannot be predicted. What this table does support, however, is the notion that if there are two converting companies which, after their conversions, have *MVR*s of 70 percent, the company that increased its book value by 25 percent must have a *PCR* of 62.5 percent, while the company that increased its book value by 50 percent must have a *PCR* of 55 percent. This comment is particularly relevant to Table 2, showing the *NCR* for given combinations of *MVR* and *PCR*. A company could not expect, except in the most unusual circumstances, to double or triple its book value without decreasing its market to book relationship.

The first salient conclusion to be drawn from this analysis is that the aggregate amount of compensation to policyholders which will allow the company to achieve its new capital objectives depends importantly on market conditions and on the market's perception of the company; such compensation is greater for a company which is accorded a higher *MVR* by the market. This is true regardless of the amount of capital raised.

The second conclusion is that for a company which can achieve a post-conversion *MVR* of close to 100 percent, both the amount of compensation for policyholders and the amount of capital that can be raised through a public offering is materially greater than for a company with a smaller resulting *MVR*. The third conclusion is that the relative amount of compensation to policyholders could vary significantly from company to company depending on the applicable combinations of the relative amount of capital raised and the market's evaluation of the company under the then current market conditions.

Finally, a point that bears repeating, the market will make only one judgment in a conversion — at the time stock is sold publicly. Because the increase in capital resulting from the sale of stock will, in all likelihood, have increased the value of the converting company by an unmeasurable amount, no valid conclusions can be drawn from these analyses as to the impact that raising more or less equity would have had on policyholders' compensation.

Conversions without Concurrent Initial Public Offering

To what extent do these conclusions apply to the other forms of conversion? Consider first a conversion in which no additional equity is raised and participating policyholders acquire the entire ownership position (plus, possibly, cash or other compensation) in exchange for cancellation of their membership rights. This form of conversion might be the first step of a two-step conversion in which the second step involves the raising of additional capital through the public sale of an equity interest in the company. When the conversion occurs, policyholders would, as a practical matter, receive the entire market value of the company in exchange for the cancellation of their membership rights. While this form of conversion raises questions as to the type and allocation of the compensation to policyholders, it does not involve issues as to the total amount of such compensation. An equity interest in the converted company received by policyholders has no value until it can be sold. The company employing this form of conversion will be under considerable pressure to establish a public market in stock at an early date. When it does, regardless of whether a market is being established to permit policyholder/shareholders to dispose of their stock or to raise equity capital as the second step of a two-step conversion, the preceding analyses, illustrations and conclusions are directly applicable. The only major difference is that the date for measurement and analysis purposes is the date of public market establishment or offering and not the original conversion date.

With respect to conversions in which the converted company is immediately acquired by another entity, the analytical process is more complex. Participating policyholders will usually receive cash or other consideration in exchange for cancellation of their membership rights in this form of conversion. In addition, the purchase price will include a "control premium" over the fair market value as compensation for the added value of control. Despite these differences, Expression 7 is applicable, although MVR should be determined by using the acquisition cost as the new shareholders' equity value (IPO) and as the company's market value.

Conversion Legislation and Regulations

The Task Force did not carry its analyses of the subject of the aggregate amount of compensation to participating policyholders into the design of conversion legislation and regulations. Based on our work, we would offer the following observations:

- We believe that there is no entitlement of policyholders to any specific value and that book value measures of policyholder contributions are not appropriate measures of value in a world in which market-determined values are the ultimate standard.
- Because, as we have shown, allowable policyholder compensation (as a percentage of preconversion book value) can vary greatly depending on market conditions and on the converting company's capital needs, the applicable law should permit the policyholder compensation , at least in some manner, to be established in recognition of specific market and company circumstances in order to permit many conversions that might benefit both the company and its participating policyholders.
- Because most mutual companies historically have not needed to achieve market level rates of earnings on capital (after policyholder dividends) and because the establishment of the closed branch may adversely impact pro-forma GAAP earnings, it is likely that many, if not most, mutual life company conversions will take place on a below-book-value basis (that is, *MVR* will be less than 100 percent). It is extremely important, therefore, that the aggregate policyholder compensation requirements of conversion laws/regulations not, effectively, preclude conversions in which market value is less than book value. For example, a requirement that policyholders receive compensation equal to GAAP preconversion book value would preclude a conversion unless the company's postconversion market value at least equaled its book value.
- The conversion process is complex for the company, which must develop a plan without sure knowledge of the actual market conditions in which the conversion will take place, and for the regulatory authorities, who must review and approve the plan with the same absence of certainty.

In these circumstances, the Task Force would suggest that the legislation offer different conversion options, covering the different forms of conversion. One option would cover a conversion in which no new capital is required immediately; in this case the entire value of the converting company would be distributed to participating policyholders at the time of conversion and additional capital could be raised months or years later as a separate step. A second option would cover the case in which the converted company is acquired immediately by another entity. A third option would cover conversions with an immediate public offering. As our analyses indicate, we do not believe that legislation can specify the aggregate amount of compensation to policyholders for each case. We believe, however, that it would be helpful and appropriate to establish minimum standards for the aggregate amount of compensation to participating policyholders for the cancellation of their membership rights. Such a legislative approach would be in the nature of a safe harbor. It would assure both the company and the regulators that, as long as the aggregate compensation to policyholders in the conversion plan met this minimum standard, the aggregate compensation element of the plan would be satisfactory and the regulatory review would be concentrated on other elements of the plan.

A safe harbor minimum might be defined as a specified amount plus an additional amount that reflects the success of the public offering. The first element could be defined as a percentage of the company's preconversion book value or as a percentage of the aggregate contributions of policyholders to the company's entity capital. The second item might be expressed as a percentage of the expected public offering amount. The key requirements are that the minimum standard provide a reasonable amount of compensation to policyholders, but not be so large and commanding that in many cases it will require the company to scale down the amount of equity capital sought to a level below that believed by its management and directors to be required or will require the company to forego or to postpone a desirable conversion.

Even with an appropriate safe harbor minimum, there will be situations in which the minimum may be so large as to prevent a desirable conversion. Therefore, this option should also contain a provision permitting conversions in which the aggregate compensation to policyholders is less than the applicable safe harbor minimum if a regulatory review establishes that the aggregate amount of compensation to policyholders is reasonable in the light of company circumstances and market conditions.

The key point to recognize, in the design of conversion legislation and regulations, is that there is no single "right answer" that fits all circumstances. Accordingly, the law and regulations must be sufficiently flexible to permit companies in different circumstances to convert. The required flexibility can be achieved through the availability of different forms of conversion and by structuring a safe harbor minimum compensation to policyholders in a conversion involving a concurrent public offering in a manner that joins the interests of the participating policyholders and the converting company.

VI. POLICYHOLDER MEMBERSHIP VALUES — INDIVIDUAL AMOUNTS

Once the aggregate amount of the policyholders' membership values is determined, this value must be allocated among eligible policyholders. As a practical matter and as a matter of perceived equity, the Task Force believes that most companies will choose to determine the membership values allocated to individual members in a manner that reflects the relative contributions of the members to accumulated capital; in addition, these values might reflect some compensation for the cancellation of the less tangible attributes of membership, the right to vote for directors, and so on. The measurement of policyholders' contributions is the subject on which actuarial science can shed the most light. The Task Force has explored, in depth, the theory and methods involved in the allocation to members of the aggregate amount of policyholder conversion compensation and believes that this work represents a significant contribution to the knowledge in this area. Our conclusions are described in the next few paragraphs.

In determining the policyholders' contributions, the generalized formula which the Task Force recommends is that the policyholders' contribution be determined as the excess of

(1) the amount of assets accumulated in the company with respect to that policy (or group of policies) including any assets derived from implicit or explicit capital charges over

(2) the amount(s) required with future premiums to mature the policy (or group of policies) and to pay policyholder dividends.

For purposes of (1), the assets accumulated reflect premiums and investment income less claims, dividends, expenses and taxes.

The determination of the amount of assets accumulated for a policy or group of policies involves actual experience. There are a few philosophical questions and more than a few practical questions that merit some attention. Two of the more important philosophical questions are: What is the proper relationship between the determination of assets accumulated and the historical treatment of various types of earnings and loss items in the dividend scale? And, how should gains and losses on surrenders and other voluntary terminations be handled in the asset accumulations for in-force policies? Our conclusion with respect to the first question is that the asset accumulations for mutual company conversion actions should be made on the same basis as the historical dividend processes. With respect to the second question, the most straightforward approach, and the one that is easiest to implement and to understand, is an approach in which the asset accumulations are determined on the assumption that the gain or loss on voluntary terminations should not be credited or charged to in-force policies. Other approaches have reasonable theoretical justification. This subject is discussed in the second half of Appendix 5, and the results are illustrated for three different approaches. The Task Force does not believe that any of the three approaches discussed is superior, in theory, to the others. At the same time it must be observed that Approach 1 is the easiest to implement, most understandable to nonactuaries, and usually will produce the largest accumulations for in-force policies.

Finally, some considerations to be taken into account in establishing the assumptions used in the accumulated asset calculations are discussed at the end of Appendix 5. In general, the view of the Task Force is that these calculations should be based on actual historical experience as it would have been analyzed and applied year-by-year in the dividend decisions.

Although there are many possible broad approaches to the determination of the amounts required, the Task Force identified three general approaches as having possible application in the measurement of policyholders' contributions in the conversion process. These three approaches are discussed in the following paragraphs.

The first approach is to set the amount required equal to the amount of statutory reserves and liabilities. The second approach would define the amount required as the amount that, with future premiums, would be sufficient to meet policy guarantees and to pay dividends on the current scale if current experience continues. The third approach would define the amount required as the amount determined for the second approach plus an additional amount to provide an appropriate (and defined) level of earnings to the enterprise.

The first approach was once thought to be the most appropriate and, possibly, the only approach to be used in conversion value determinations. This approach would also be consistent with those conversion statutes where the aggregate membership value is based largely on statutory surplus. In the view of the Task Force the amounts determined using this approach would only by chance represent a good measure for individual policies of the amounts that are required with future premiums to mature the policy (or group of policies) and to pay policyholder dividends. This approach has an additional serious deficiency as a conversion allocation methodology because it will produce negative contributions for most of a company's current individual policyholders. Therefore, it is not a useful method and, in addition, the Task Force does not believe that it produces a theoretically correct measure of policyholder contributions, in the aggregate or policy-by-policy. For these reasons, the Task Force did not believe that there was any reason to explore this first approach in greater detail.

With respect to the second approach, the Task Force believes that the initial amount of assets in the closed branch is probably the best measure of the assets required to meet the contractual guarantees and the dividends that would be payable if current experience continues. If this definition of amounts required is used, the policyholders' contribution turns out to be "the accumulated value of past contributions to surplus plus the present value of future contributions to surplus."

This second approach has three major advantages as a measurement of policyholders' contributions. The first advantage is that it is easy to describe and understand. The second advantage is that, because of the interrelationship between the policyholders' contribution determination and the amount of closed branch assets, it assures that the policyholder will receive full credit, in dividends or in the basis of allocating the aggregate amount of policyholder compensation, for the amount of assets that the policyholder has contributed to the converting company and that will not be required for policy benefits, expenses and taxes. The third advantage is that this approach will produce positive values at all durations if the policy or policy class is expected ultimately to make a contribution to surplus.

Note that the second approach to determining amounts required cannot appropriately be used for group insurance or for other lines of business which are continuing in nature and for which a closed branch operation is not appropriate.

The Task Force believes the third approach would be the method used for lines of business not included in the closed branch. This is discussed in more detail in Appendix 6. The Task Force also believes this approach could be used with a stock company participating branch dividend methodology, as described previously in Sections III and IV. The Task Force did not develop this methodology but believes it is worthy of some additional study. We believe that this study needs to cover only the earnings element because the other elements have already been covered by the work on the closed branch.

VII. ACCOUNTING ISSUES

The converting company would have to prepare financial statements on a GAAP (Generally Accepted Accounting Principles) basis. If the converting company uses a closed branch approach to the management of its preconversion participating business, the GAAP standards and practices applied to the converting company would not differ materially from those generally applicable to stock life insurance companies, except for the treatment of the closed branch business. For the closed branch business, initial indications are that public accountants will agree that the GAAP liabilities should be equal to the amount of closed branch assets (measured on a GAAP basis) unless tests show that the amount of assets in the closed branch, together with premium income, is insufficient to pay guaranteed benefits. The GAAP earnings on closed branch business will be zero, unless the closed branch has been established and funded on a basis that specifically provides for a defined earnings flow.

The likely GAAP treatment of the closed branch will result both in GAAP capital being larger on the date of conversion and in future GAAP earnings being smaller than they would have been if a closed branch had not been established. This result will affect the company's apparent return on equity, and it may reduce the attractiveness of the stock to investors in the converted company. This disadvantage would not apply to segments of business not included in a closed branch because the present value of future earnings on such segments would not be brought into GAAP equity at conversion.

The statutory earnings with respect to closed branch business must be worked out on a state-by-state basis or by the National Association of Insurance Commissioners (NAIC). The basic question is the degree to which the closed branch asset total (as measured on a statutory basis) should be recognized as a satisfactory measure of liabilities for the business in the closed branch. The general approach to statutory accounting weighs heavily against such a change in practice, but there is no precedent for a closed branch operation. The Task Force undertook no further work on this subject.

A committee formed by the Task Force addressed the issue of management financial statements of mutual life insurance companies and has produced a separate report on that subject which was published by the Financial Reporting Section in 1987.[6] This committee comprised a number of members of the Task Force plus representatives from a number of other mutual companies and consultants interested in this subject. Much of the discussion in that report complements or supplements discussion of related concepts in the Task Force Report and is suggested reading for anyone wishing a fuller understanding of the rationale underlying the conclusions presented in the Task Force Report.

VIII. DEMUTUALIZATION OUTSIDE THE UNITED STATES

The Task Force has found that the complex actuarial issues associated with demutualization cannot be considered in isolation from other considerations, such as regulatory framework, legal precedents, financial market operations, and accounting principles. The Task Force has attempted to be governed by actuarial concepts in arriving at the conclusions discussed in this report; however, it is acknowledged that these concepts have been heavily influenced by principles and practices in the United States.

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[6] LIFE INSURANCE COMPANY FINANCIAL REPORTING SECTION COUNCIL. *Report of the Committee on Accounting Principles for Management Financial Statements of Mutual Life Insurance Companies.* Itasca, Ill.: Society of Actuaries, January 14, 1987.

At the time of this writing, no major demutualization has been attempted in Canada, nor is there any provision in the federal insurance laws for demutualization. However, Canadian law does have provisions for the transfer of business between companies. This law provides a key role for an independent actuary whose responsibility is to assure policyholders and the government, and sometimes the courts, that participating policyholders are well served by the transaction. It is quite possible that in Canada and other British Commonwealth countries the actuarial principles and the laws might place primary emphasis on the protection of the future expectations of policyholders and less emphasis on fair membership, or equity, value than that implied in the recommendations of the Task Force.

In Canada, at this time, the federal statutory basis of valuation is also the accepted GAAP standard for both stock and mutual companies and for participating and nonparticipating business of both types of companies. The role of the valuation actuary is critical in ensuring that the valuation is appropriate for both purposes and is acceptable to both regulators and accountants. Therefore, this leads to a somewhat different accounting model from that which would apply in the United States.

APPENDIX 1

MODEL OF MUTUAL LIFE INSURANCE COMPANY FINANCIAL OPERATIONS

Part 1

This appendix presents the modeling work done by the subcommittee (working with Millman & Robertson).

The Task Force needed a tool to use in judging the effectiveness and appropriateness of different concepts and methods which might be applied in the conversion of a mutual life insurance company to a stock corporation. For this purpose, the subcommittee built a model company from scratch, rather than trying to exhaustively examine a real company with its own unique (and partially unknown) history. To simplify analysis, the model assumes a single economic (and tax) environment with no changes in experience factors over the lifetime of the model company. The model uses a dynamic dividend-setting process which incorporates the surplus constraints faced by real companies. Despite the artificiality implied (by the use of "constant") assumptions, the model has proven to be very useful in our work.

The model has been helpful in the following specific ways:

1. To examine (under alternative theories of attribution) the source of surplus by different generations of policyholders (that is, issue years) in a mutual company.
2. To examine (under alternative theories of attribution) how much surplus has been developed by policyholders in force and how much surplus has been developed by terminated policyholders.
3. To illustrate the effects of different company growth rates.
4. To illustrate the future operations of a closed branch created to help assure that the reasonable dividend expectations of participating policyholders will be obtained after a conversion.
5. To illustrate the effects of different methods of allocation of the aggregate policyholder consideration required to be paid upon demutualization.
6. To illustrate the effects of different conversion accounting approaches.
7. To illustrate the effects of different conversion approaches.
8. To explore the ways in which a mutual company builds and maintains its capital structure.

Our work with the model company concentrated primarily on items 1 through 5 and 8 cited above; very little was done on items 6 and 7.

I. MODEL DESIGN

This section highlights a few of the more important assumptions used in the design of the model. Part 2 of this appendix contains a complete statement of assumptions.

The model company operates 75 years as a mutual life insurance company and then converts to a stock form of ownership. The model company issues only whole life contracts before conversion, and the whole life product never changes over the 75-year period except for dividend scale changes.

The inflation rate is assumed to be 5 percent. The company has a steady 8 percent growth rate in face amount of new business issued. The company earns net investment income of 8.65 percent on nonloaned assets. The tax law is the DEFRA tax law as enacted in 1984.

The company maintains a constant 5 percent ratio of surplus to reserves using two mechanisms. In its early years the company borrows surplus and pays the interest earned on this surplus to the lender. In the early years, until the company has a 5 percent surplus ratio without counting the borrowed surplus, the company pays a standard dividend scale (shown in Part 2 of this appendix). After the surplus note is repaid from the company's internal earnings, the company is able to increase its dividend scale and still maintain its surplus at 5 percent of reserves.

The real growth rate in new business issued for the model company is 2.9 percent (the net of an 8 percent normal growth rate and a 5 percent inflation rate). One might ask whether the 2.9 percent real growth rate assumption is plausible. To test this, we looked at the history of nine large mutual companies for the 75-year period from 1909 to 1984. We looked at the growth rates in individual life insurance reserves, in individual life insurance face amounts, and in total company assets. The 75-year (geometric) average inflation rate in the Consumer Price Index between 1909 and 1984 has been 3.25 percent annually. The real growth rate (after factoring out the 3.25 percent inflation) for these nine companies ranges from:

- 0 percent to 4 percent for individual life insurance reserves,
- 1 percent to 4.5 percent for individual life insurance face amounts, and
- 0.7 percent to 6.2 percent for total company assets.

The new business growth rate is the rate toward which the growth rate of in-force business moves; therefore, the relationship between the growth rate and inflation rate in the model does fall within the range of the real growth rates of the nine large mutual life insurance companies. We conclude that the growth rate assumption is plausible in the economic environment assumed.

The model company is an instructive tool, but is not necessarily representative of the history and current structure of any particular company. Not only have experience factors and tax laws varied over the years for real companies, but actual company results may not be consistent with the model company results developed in the balance of this paper for other reasons such as recent growth in other lines of business (including nonparticipating universal life insurance), faster or slower than average growth in later years and higher than average lapses in later years. Therefore, actuaries should be cautious in using these results in specific company situations.

II. PROJECTION RESULTS FOR TOTAL COMPANY

We projected the model company for its first 75 years (to the date when it converts). In Part 4 of Appendix 1, Tables A through C contain the results for the company since inception.

In Table A the statutory summary of operations by decade (five years only in the final column) is presented. In Table B the balance sheet, in 10-year intervals starting with the fifth year, is displayed. The growth of the surplus loan over several years and repayment over the following years is evident in Table B. The surplus note is paid off within 35 years. After 40 years, we allowed the dividends to differ from the standard scale by a single factor applied to all dividends paid in that year. The factor was set to increase the dividend liability so as to reduce the surplus to 5 percent of reserves. The single factor adjustment was a simplifying technique, used in lieu of a more precise three-factor formula, to achieve

- immediate adjustment of surplus to the target level.
- adjustments of dividends which in the aggregate approximate those which would have been derived by a more precise technique.

Table C shows the modifications to the dividend scale. Over the last 30 years before demutualization, the applicable dividend modification is a fairly flat extra 15 percent.

III. ANALYSIS OF FINANCIAL RESULTS BY YEAR OF ISSUE AND BY SURVIVORS VERSUS TERMINATED CONTRACTS

The total company model was developed issue-year-by-issue-year, permitting us to analyze the financial results by issue years. In Table D the face amounts of insurance by generation (issue year or issue year grouping) are presented: The amounts issued (Column 1), the amounts still in force at the conversion date, which is the end of the 75th year (Column 2), and the difference in Column 4 being the amounts issued but since terminated (by death, maturity or surrender) before the conversion date. Except for the most recent six years' issues, the majority of issues have already terminated (that is, Column 4 is larger than Column 2 except for issue years 70–75). Of the total amount issued, 45 percent is in force and 55 percent has terminated. Column 3 of Table D represents a cumulative distribution by face amount for the contracts in force; 54 percent of all face amounts in force were issued within the most recent five years; 77 percent of all face amounts in force were issued within the most recent ten years; 96 percent of all face amounts in force were issued within the most recent 22 years. The distribution by policies would be less heavily concentrated in the most recent years than the distribution by face amount.

In Appendix 5 three possible approaches to the attribution of gains and losses on termination are discussed. The approach examined in Appendix 5 is Approach 1: To charge in-force policies with the cost of insurance, but not with any gains or losses arising from terminations.

In Table E the assets, liabilities, and surplus arising from contracts in force are displayed, including terminated contracts and all contracts analyzed by issue year. Over 90 percent of the current total assets arose from the contracts in force. However, the required statutory reserves and liabilities are greater than the assets arising solely from the contracts in force. Survivors, as a group, have negative surplus because the net new business strain on recent issues still in force is greater than the positive surplus generated by the (fewer) survivors from less recently issued contracts. More than 100 percent of the company's statutory surplus came from contracts that are now terminated.

Tables F, G, and H present some data on terminated contracts that were issued during the first 58 years of the operation of the model company. We study terminated contracts separately because the final amount of their contributions to surplus is known. Survivors are still receiving dividends, and their final contributions to surplus are not known. Column 1 of all three tables contains the assets left with the company (that is, the permanent contributions to surplus) by terminated contracts. These amounts are taken from the next to last column in Table E. The following columns compare the permanent contributions to surplus by terminators to the cumulative premium paid by these policyholders (in Table F), to the cumulative face amounts insured on these policyholders (in Table G), and to the cumulative gross income (premium and net investment income) attributable to these policyholders (in Table H).

The last two columns in Table F (Columns 4 and 5) display the level percentage of premium that would accumulate to the surplus shown if that premium were accumulated at 2.4668 percent and 5.4668 percent, the after-tax rates with and without the equity tax, respectively. Similarly, the last two columns in Table G display the level amount per $1,000 face amount per year that would accumulate to the surplus shown if those amounts were accumulated at 2.4668 percent and 5.4668 percent. Finally, the last two columns in Table H display the level percentage of gross income that would accumulate to the surplus shown if those amounts were accumulated at 2.4668 percent and 5.4668 percent.

Contracts issued in the first year received the standard dividend scale for 40 years. Only those contracts persisting beyond 40 years received an improved dividend scale. In contrast, contracts issued in year 41 received the improved dividend scale in all years. Because more than 90 percent of the contracts issued in year 41 have terminated before the date of demutualization, the 4.3 percent (in Column 4 of Table F for contracts issued in years 39–43) would not change much in the next 40 years if the company were to continue operating as it did in year 75. Thus, the difference between the 9.5 percent of premium contribution to surplus (by contracts issued in year one) and the 4.3 percent of premium contribution to surplus (by contracts issued in year 41) is the price paid by the original insureds to help build the surplus of the company. Similar interpretations apply to the comparable lines under Column 4 of Tables G and H.

Column 4 in each of the Tables F, G and H contains a comparison of the permanent contribution to surplus with a quantity accumulated at the interest rate at which surplus accumulates after all taxes, including the equity tax. Once an issue year group has completely terminated, the Column 4 ratio will not change because both the numerator and the denominator increase at 2.4668 percent annually. The values in Column 5 of these tables exclude the effect of the equity tax. The differences between entries in Columns 4 and 5 show the financial effect of the equity tax.

If a company (operating under a tax law that has no equity tax) managed its affairs to have contributions to surplus by issue year identical to those in Column 1 — which is not implausible for a company with the same growth and the same statutory surplus requirements as the model company studied here — then the entries in Columns 5 of Tables F, G and H represent the permanent contributions to surplus by terminated contracts in relation to premium, face amount and gross income. These columns suggest that the original insureds of these companies made permanent contributions to surplus that can be measured as 1.5 percent to 2 percent of premium, or as 35¢ to 50¢ per $1,000 face amount per year, or as 1 percent to 1.5 percent of gross income.

Once the surplus has been built up, more recently issued contracts are leaving less permanent contributions to surplus; the dividend scale is more generous.

Table G shows permanent contributions to surplus in relation to amounts insured. One should be careful to recognize the difference between this basis and the basis used by states such as New York to limit the profit which stock life insurers may transfer from the participating branch to the stockholder branch. Stock life insurers may transfer annually the greater of 10 percent of predividend profits and 50¢ per $1,000 face amount. However, stock life insurers may also retain amounts of surplus in the participating branch, and the surplus thus retained in the participating branch can help support new business strain, relieving stockholders of that burden.

Table H makes its comparisons of surplus to gross income. Of all the income generated by the contracts issued in a year, most of it goes to pay death benefits, surrender benefits, expenses or taxes. Only the small proportion shown in Column 4 or in Column 5, depending on the tax law, goes to build the capital structure (surplus) of the company.

IV. CLOSED BRANCH OPERATIONS

When the company converts to a stock company, it may wish to place the existing participating policyholders in a closed branch with enough assets, together with future premiums, to pay all benefits, expenses, taxes and dividends (on the current scale) if current experience continues.

We have projected the closed branch using the following current assumptions:

1. The premiums, cash values, and policy loan rates (as specified in Part 2 of this appendix) remain as guaranteed.
2. The net investment income rate, policy loan utilization rate, mortality rates, lapse rates, commission rates, and percentage of premium expense rates are the same as specified in Part 2 of this appendix.
3. No new business is added to the closed branch.
4. Unit expense rates, other than percentage of premium expense rates, increased 5 percent annually after conversion. As of the date of conversion, these expense rates are the expense rates given in Part 2 of this appendix increased 5 percent per year for 74 years. (Whether "current experience" should mean "current unit expenses with no inflation" or "current unit expenses with current inflation rates applied" would depend upon, among other things, a particular company's dividend practices.)
5. Taxes are paid at 36.8 percent of the increase in the excess of assets over tax basis reserves; no equity tax is charged.
6. The dividend scale used throughout the closed branch period is the scale in effect at the date of conversion.

Under these assumptions the initial assets necessary to fund the closed branch are $1,830.6 million ($519.4 million of policy loans and $1,311.2 million of other invested assets), as shown in Table I.

In Table I the cash flows of the closed branch after conversion are also shown.

Table I (Detail) contains the cash flows from both the initial (nonpolicy loan) investments and the reinvestments on lines A.1, A.2, and A.3. The maturities reflect the investment history of the company, which bought only 10-year bonds. In the final 20 years (at least 55 years after the conversion) some bonds have to be sold (at par), or money has to be borrowed, to pay required insurance cash flows in certain years; in reality a company would not be locked into buying only 10-year bonds at all times, thus avoiding the subsequent need to sell bonds. In Table I (Detail) the required cash flow is obtained by borrowing at the same 8.65 percent interest rate; this produces negative investment maturities 10 years later when the loans are repaid.

Lines A.4 through A.11 show the insurance cash flow items (including policy loans). Line A.12 is the net cash flow (from both investments and insurance) available for reinvestment in 10-year bonds. Sections B, C, and D present noncash items for reference. Line C.5 (the excess of assets over statutory liabilities in the closed branch) is initially negative and increases to zero over 75 years.

Table I (Summary) contains highlights of lines A.11, A.2, A.1, and A.12 from from Table I (Detail). This summary emphasizes that the net cash flow is positive until the closed branch nears its end.

Table J contains a comparison of the assets accumulated to date by the contracts in force (Column 1 of Table E, reproduced as Column 1 in Table J) with the assets required initially to fund the closed branch (Column 2 in Table J). The difference between these two columns (Column 3 in Table J) is the aggregate amount (for all participating policyholders) of the policyholders' contributions determined according to the second (and preferred) approach described in Section VI of the report. The difference between the two columns for any generation is the current value of all past and all future contributions to surplus by the policies in force.

For the model company, whose experience always matched its pricing assumptions, for every issue year, the accumulated assets on contracts in force exceed the prospectively required assets on the same contracts.

To illustrate the relative size of this measurement of policyholder contributions, Column 5 of Table J represents each issue year's policyholder interest divided by the face amounts now in force that were issued in that year. Another illustration of relative size appears in Column 7: each issue year's policyholder interest is divided by the cash values in force. As suggested elsewhere in the report, the numerical results of Table J are not necessarily applicable to any particular company.

The assets needed to maintain the current dividend scale (Column 2 of Table J) are less than the statutory reserves and liabilities (shown in Table E) because

- the dividend scale and the cash value structure have provision for recovery of unamortized initial acquisition expenses, and
- the dividend scale has an implicit provision for the cost of capital which is not charged explicitly against the closed branch.

V. ALTERNATIVE GROWTH RATE

To test the sensitivity of the results obtained to the particular growth rate assumed, the subcommitte developed a second model company with a 5 percent growth rate in new face amount issued. (This implies no growth in number of contracts sold, only in average face amounts.) We assumed that such a slow growth company would have somewhat higher expense rates, a lower net investment income rate, and a higher ratio of surplus to reserves. (See Part 2 of this appendix for the details.) The 5 percent growth company can still remain competitive, paying in most years approximately the same dividend scale as the 8 percent growth company.

Tables AA, BB, CC, DD, EE, FF, GG, HH, II, and JJ in Part 4 of this appendix are for the 5 percent growth company and are comparable to Tables A through J in Part 3 (of this appendix) for the 8 percent growth company.*

As one would expect, the 5 percent growth company has a smaller proportion of recently issued business than has the 8 percent growth company. Table DD shows 69 percent of the business in force was issued within the last 10 years, in contrast to 77 percent in Table D for the 8 percent growth company. Only 36 percent of all contracts ever issued by the 5 percent growth company are still in force, in contrast to 45 percent for the 8 percent growth company.

The lower new business strain in the slower growth company creates less difference between the surplus accumulated by survivors and the total company surplus as seen by comparing Tables E and EE. The amounts are smaller in the smaller company, but the proportions are similar. For example, the assets left by terminated contracts are still roughly twice the statutory surplus in the 5 percent growth company, just as in the 8 percent growth company.

Tables FF, GG and HH use accumulations at 2.056 percent and 5.056 percent, the after-tax rates (with and without the equity tax) available to a company earning 8 percent. The faster growth company earned somewhat higher rates. The slower growth company carried a larger surplus in relation to reserves than did the 8 percent growth company, but the slower growth company had less new business strain. Both paid similar dividends to policyholders. Thus, the policyholder's net cost was the same at both companies.

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*The current dividend scale for the closed branch of the 5 percent growth company is 114.5 percent of the standard dividend scale, rather than 114.66 percent.

The relatively older business in the closed branch of the slow growth company means that there is less difference between the assets accumulated by survivors and the assets needed for the closed branch in the slow growth company; compare Tables J and JJ. Accordingly, the aggregate amount of the policyholders' contributions is much smaller in the case of the slower growth company than in the case of the vigorously growing company.

Part 2

Model Company Assumptions

ENVIRONMENT	
Net investment income:	8.65% on invested but nonloaned assets (but 8% for the slower growth company).
Policy loan utilization:	25% of cash values are loaned.
Inflation:	5% annually in policy size of new business issued and in expenses other than percentage of premium expenses.
Income taxes:	36.8% of the tax basis gain from operations (i.e., statutory gain plus increase in statutory reserve and dividend liability minus increase in tax basis reserve) plus 3% of the end of year tax basis surplus (the latter term is applied only through the conversion date).
COMPANY HISTORY	
New business sold:	10,000 units of $1,000 face amount sold in the first (single) calendar year, increasing thereafter at 8% (5% for slower growth company). The first 65 years' business is modeled as 13 years of issue, each 5 years apart. Since each group is assumed issued at its midpoint, the midpoint of the first generation in the model is called year one. The conversion occurs 75 years later (end of year 75).
Distribution of units sold:	30% age 25 40% age 40 30% age 55
Surplus policy:	Assets are borrowed as needed in order for surplus to be 5% of reserves (7% of reserves for the slower growth company) in the first 40 years. Borrowed surplus is repaid as soon as possible (consistent with the criterion above) together with any interest (net of any tax) earned on the amount borrowed.

MODEL COMPANY ASSUMPTIONS—*Continued*

Dividend philosophy:		For first four decades, pay standard dividends. Thereafter, increase or decrease dividends from standard scale to move surplus to target 5% of reserves (but 7% of reserves for the slower growth company). See the end of Part 2 of this appendix for standard dividend scale. See Part 3 of this appendix for asset share surpluses based on standard dividend scale and asset share surpluses based on dividend scale increased to 115% of standard.
PRODUCT Plan:		Whole life — male Age Nearest Birthday (ANB)
Average size:		$50,000 inflating 5% annually for new issues.
Premium, annual per unit:		Age 25: $11.02 Age 40: $19.43 Age 55: $38.24 plus $25 policy fee per policy per year.

Cash values per unit:

	Duration			
Age	1	2	3	4
25	$0	$ 0	$ 7	$15
40	0	6	22	37
55	0	17	44	71

Cash values grade into 4.5% 1958 CSO continuous functions CRVM terminal reserves by end of 20th year.

Reserves:	Statutory:	4% 1958 CSO continuous functions CRVM.
	Tax:	6% 1958 CSO continuous functions CRVM but not less than cash values.
Policy loan interest rate:		7%

Expenses
Percent of premium (commissions, premium taxes, etc.)

Year	% Premium
1	93.0%
2	14.0
3–5	13.0
6–8	12.5
9+	7.5

Per policy:*

At issue:	age 25	$106.250
	age 40	$123.250
	age 55	$133.875
Annually:	$36.125	

Per claim:*	$21.25
Per surrender:*	$8.50
Mortality rate:	70% of 1965–70 male ANB select and ultimate intercompany study; all benefits taken in cash.
Lapse rate:	100% of Linton B; all benefits taken in cash.

MODEL COMPANY ASSUMPTIONS—*Continued*

		Issue Age		
Dividend per unit (Standard Scale)	Duration	25	40	55
	1	$ 0.00	$ 0.00	$ 0.00
	2	1.75	2.07	3.84
	3	1.86	2.35	5.29
	5	2.14	2.95	8.18
	10	2.93	4.78	15.58
	15	3.39	7.05	19.46
	20	4.16	9.60	22.81
	30	7.01	15.90	25.53
	40	12.15	21.35	31.06
	50	17.54	25.25	—

*As specified above, these expenses inflate 5 percent per year after the first year. The expense rates for the slower growth company are 117.65% of these expense rates (other than Percent Premium).

Part 3

This part of the appendix presents the asset share surpluses in relation to reserves in force, developed by blocks of business with the experience specified in Part 2 if the company always pays the equity tax and if the dividend scale were always a single multiple (either 100% or 115%) of the standard dividend scale.

A measure of the aggregate effect of both experience assumptions and dividend scale is the asset share surplus development. Underlying the surplus development in the model company is the surplus development for a block of business issued in a single year. This appendix shows the aggregate effect of the assumptions in Part 2 for a block of business issued in a single year under two assumptions:

1. that the dividend scale was always a single multiple of the standard scale shown in Part 2, and
2. that the company was always a mutual company paying both the gains tax and the equity tax (either of which will be negative if its base is negative).

As explained in Part 2, the dividend formula used in the model was not set from year-to-year using a three-factor formula, but rather it was set as a simple multiple of a standard dividend scale, which had been paid in the first 40 years. Thus, the model company's dividend formula will not be as equitable among issue ages and issue years as would be a more complex dividend formula.

Because the asset share surplus discussed here (in Part 3) is studied for blocks of business rather than for individual policies, the surplus or deficit left by terminating policies remains in the asset share surplus. In contrast, the methodology used elsewhere in the report to determine the assets accumulated by policies in force regards the surplus or deficit left by terminating policies as associated with those terminating policies.

If the dividends paid were always 100 percent of the standard scale, the asset share surplus to reserve ratio depends on the investment and expense experience of the company as follows:

RATIO OF ASSET SHARE SURPLUS TO RESERVES
(AFTER ALL TAXES AND AFTER DIVIDENDS AT 100% OF STANDARD)

Issue Age	At End of Calendar Year *N* (Policy Duration *N* − ½)	Better Investment and Expense Experience (From 8% Growth Company)	Poorer Investment and Expense Experience (From 5% Growth Company)
25	5	−21.1%	−24.7%
	10	− 5.8	−10.1
	15	+ 3.8	− 1.8
	20	+13.0	+ 5.5
	25	+22.9	+13.0
	30	+34.9	+21.4
40	5	−13.9%	−16.3%
	10	− 2.7	− 6.0
	15	+ 6.2	+ 1.3
	20	+14.9	+ 7.9
	25	+26.1	+15.8
	30	+42.7	+27.1
55	5	− 8.7%	−10.5%
	10	− 1.8	− 4.9
	15	+ 5.1	− 0.1
	20	+14.2	+ 5.9
	25	+31.1	+16.5
	30	+69.0	+39.9

If the dividends paid were always 115 percent of the standard scale (that is, the dividend scale as of the date of conversion), the asset share surplus to reserve ratio depends on the investment and expense experience of the company as follows:

Ratio of Asset Share Surplus to Reserves (After All Taxes and After Dividends at 115% of Standard)

Issue Age	At End of Calendar Year *N* (Policy Duration *N* − ½)	Better Investment and Expense Experience (From 8% Growth Company)	Poorer Investment and Expense Experience (From 5% Growth Company)
25	5	−23.9%	−27.4%
	10	− 9.2	−13.4
	15	− 0.2	− 5.7
	20	+ 8.2	+ 1.0
	25	+17.2	+ 7.5
	30	+27.6	+14.5
40	5	−15.8%	−18.2%
	10	− 5.4	− 8.7
	15	+ 2.4	− 2.4
	20	+ 9.8	+ 2.9
	25	+18.9	+ 8.9
	30	+32.2	+17.1
55	5	−11.4%	−13.2%
	10	− 6.6	− 9.6
	15	− 2.3	− 7.1
	20	+ 2.9	− 5.1
	25	+12.4	− 1.3
	30	+33.9	+ 7.0

Part 4

TABLE A

Model Company Summary of Operations (8% Growth Company) ($ Millions)

	Years							
	1–10	11–20	21–30	31–40	41–50	51–60	61–70	71–75 (five years only)
Premium Income	$15.5	$45.2	$104.0	$227.5	$492.2	$1,063.1	$2,413.5	$2,045.7
Net Investment Income*	2.4	13.7	40.9	99.2	219.4	474.8	1,027.8	892.6
Death Benefits	1.4	6.7	19.6	47.3	105.6	229.9	500.8	434.7
Surrender and Endowment Benefits	1.5	7.5	20.4	47.1	103.5	224.3	484.9	420.0
Increase in Reserves	7.3	19.8	41.4	85.7	181.7	390.5	867.8	739.9
Commission and Agency Expense	4.3	10.1	22.2	48.2	104.1	224.7	582.0	468.7
Administrative Expense	1.2	3.5	8.4	18.7	40.7	88.2	207.7	173.6
Cash Dividends Paid	1.7	7.8	20.3	46.1	118.4	249.4	537.8	468.7
Increase in Dividend Liabilities	0.4	0.8	1.7	3.6	14.0	24.4	35.5	36.5
Federal Income Tax	0.5	2.3	7.7	20.5	39.2	87.0	181.4	159.1
Net Gain	(0.4)	0.4	3.2	9.5	4.4	19.5	43.4	37.1

*Interest earned on assets corresponding to surplus note is offset by interest paid on surplus note, which is charged against this Net Investment Income line.

TABLE B

MODEL COMPANY BALANCE SHEET
(8% Growth Company)
($ Millions)

	End of Year							
	5	15	25	35	45	55	65	75
Assets								
Non-Policy Loans	$2.2	$13.4	$38.3	$ 91.0	$201.8	$437.0	$ 964.6	$2,050.9
Policy Loans	0.5	3.4	10.0	23.5	51.8	112.4	245.0	519.4
Total	2.7	16.8	48.3	114.5	253.6	549.4	1,209.6	2,570.3
Liabilities								
Reserves	2.4	15.3	44.2	103.5	228.0	494.2	1,096.9	2,334.1
Dividend Liability	0.2	0.7	1.9	4.4	14.2	30.5	57.4	116.9
Federal Income Tax Liability	0.0	0.0	0.0	0.0	0.0	0.0	0.4	2.6
Total	2.6	16.0	46.1	107.9	242.2	524.7	1,154.7	2,453.6
Surplus Note	0.4	1.4	1.3	0.1	0.0	0.0	0.0	0.0
Unassigned Surplus	(0.3)	(0.6)	0.9	6.5	11.4	24.7	54.9	116.7

TABLE C

MODIFICATIONS TO DIVIDEND SCALE
(8% Growth Company)

Year	Dividend Paid ($ Millions)	Standard Dividend ($ Millions)	Ratio
41 – 45	49.3	40.7	121%
46 – 50	69.1	60.0	115
51 – 55	100.7	88.3	114
56 – 60	148.7	129.8	115
61 – 65	213.1	190.7	112
66 – 70	324.7	278.1	117
71 – 75	468.7	407.5	115

TABLE D

FACE AMOUNT OF INSURANCE AS OF CONVERSION DATE
(8% Growth Company)
($ Millions)

		In Force on Conversion Date		
Issue Year	(1) Total Issued	(2) Amount	(3) Cumulative Distribution	(4) = (1) − (2) Terminated Prior to Conversion
1 – 3	59	0.01	100%	59
4 – 8	86	0.10	100	86
9 – 13	127	0.30	100	127
14 – 18	186	1.00	100	185
19 – 23	273	3.00	100	270
24 – 28	402	8.00	100	394
29 – 33	590	21.00	100	569
34 – 38	867	49.00	100	818
39 – 43	1,274	109.00	100	1,165
44 – 48	1,873	233.00	99	1,640
49 – 53	2,752	478.00	98	2,274
54 – 58	4,043	944.00	96	3,099
59 – 63	5,940	1,811.00	91	4,129
64	1,488	532.00	82	956
65	1,607	608.00	80	999
66	1,735	694.00	77	1,041
67	1,874	797.00	74	1,077
68	2,024	917.00	70	1,107
69	2,186	1,062.00	65	1,124
70	2,361	1,241.00	60	1,120
71	2,550	1,461.00	54	1,089
72	2,754	1,734.00	47	1,020
73	2,974	2,086.00	39	888
74	3,212	2,565.00	29	647
75	3,469	3,467.00	17	2
Total	46,706 (100%)	20,821 (45%)		25,885 (55%)

TABLE E

ASSETS, LIABILITIES, AND SURPLUS AT CONVERSION BY ISSUE YEAR
(8% Growth Company)
($ Millions)

	Assets Accumulated by			Reserves and Liabilities In Force	Surplus Accumulated by		
Issue Year	Contracts In Force	Terminated Contracts	All Contracts		Contracts In Force	Terminated Contracts	All Contracts
1 - 3	0.02	7.0	7.0	0.01	0.01	7.0	7.0
4 - 8	0.10	9.0	9.1	0.10	0.05	9.0	9.0
9 - 13	0.40	11.4	11.8	0.30	0.10	11.4	11.5
14 - 18	1.40	14.0	15.4	0.90	0.50	14.0	14.5
19 - 23	3.70	16.9	20.6	2.60	1.10	16.9	18.0
24 - 28	8.80	19.5	28.3	6.40	2.40	19.5	21.9
29 - 33	19.70	21.1	40.8	14.90	4.80	21.1	25.9
34 - 38	40.10	21.2	61.3	31.90	8.20	21.2	29.4
39 - 43	76.20	20.7	96.9	63.70	12.50	20.7	33.2
44 - 48	136.60	20.6	157.2	120.10	16.50	20.6	37.1
49 - 53	226.00	17.6	243.6	209.80	16.20	17.6	33.8
54 - 58	341.70	14.1	355.8	333.70	8.00	14.1	22.1
59 - 63	465.10	11.4	476.5	477.20	- 12.10	11.4	- 0.7
64	104.40	1.8	106.2	110.50	- 6.10	1.8	- 4.3
65	106.90	1.8	108.7	114.50	- 7.60	1.8	- 5.8
66	108.70	1.7	110.4	118.00	- 9.30	1.7	- 7.6
67	109.70	1.7	111.4	120.70	- 11.00	1.7	- 9.3
68	108.30	1.7	110.0	121.10	- 12.80	1.7	- 11.1
69	106.30	1.6	107.9	120.40	- 14.10	1.6	- 12.5
70	102.40	1.3	103.7	117.80	- 15.40	1.3	- 14.1
71	94.30	1.1	95.4	111.10	- 16.80	1.1	- 15.7
72	82.10	0.7	82.8	100.20	- 18.10	0.7	- 17.4
73	65.10	0.1	65.2	83.30	- 18.20	0.1	- 18.1
74	52.90	- 1.1	51.8	69.80	- 16.90	-1.1	- 18.0
75	- 7.50	—	- 7.5	4.60	- 12.10	—	- 12.1
Total	2,353.40 (92%)	216.9 (8%)	2,570.3 (100%)	2,453.60	-100.20	216.9	+116.7

TABLE F

TERMINATORS' CONTRIBUTIONS TO SURPLUS AS OF DATE OF DEMUTUALIZATION IN RELATION TO PREMIUM

(8% Growth Company)

Issue Year	(1) Terminators' Surplus on Date of Demutualization ($ Millions)	(2) Value of Terminators' Premium Accumulated at 2.4668%* ($ Millions)	(3) Value of Terminators' Premium Accumulated at 5.4668%* ($ Millions)	(4) = (1)/(2) Contribution to Surplus as a Percentage of Premium at 2.4668%*	(5) = (1)/(3) Contribution to Surplus as a Percentage of Premium at 5.4668%*
1 – 3	7.0	73.6	497.0	9.5%**	1.4%**
4 – 8	9.0	95.6	559.5	9.4 **	1.6 **
9 – 13	11.4	123.9	628.1	9.2 **	1.8 **
14 – 18	14.0	159.9	703.0	8.8 **	2.0 **
19 – 23	16.9	205.5	784.5	8.2 **	2.2 **
24 – 28	19.5	261.7	869.2	7.5 **	2.2 **
29 – 33	21.1	327.8	950.4	6.4 **	2.2 **
34 – 38	21.2	402.4	1,021.6	5.3 **	2.1 **
39 – 43	20.7	479.1	1,069.5	4.3	1.9
44 – 48	20.6	546.2	1,078.0	3.8	1.9
49 – 53	17.6	591.9	1,037.5	3.0	1.7
54 – 58	14.1	605.2	945.3	2.3	1.5

*Premium is accumulated at after-tax interest rates, with and without the equity tax, which is estimated as 3%:

2.4668% = 8.65% [1 – 46%(80%)] – 3%
5.4668% = 8.65% [1 – 46%(80%)]

**Contracts issued before year 39 received lower dividends (in years at least through year 40) than other contracts (issued in later years) received at comparable durations since issue date.

TABLE G

TERMINATORS' CONTRIBUTIONS TO SURPLUS AS OF DATE OF DEMUTUALIZATION IN RELATION TO FACE AMOUNTS

(8% Growth Company)

Issue Year	(1) Terminators' Surplus on Date of Demutualization ($ Millions)	(2) Value of Face Amounts (in Billions) Exposed per Year by Terminators Accumulated at 2.4668%*	(3) Value of Face Amounts (in Billions) Exposed per Year by Terminators Accumulated at 5.4668%*	(4) = (1)/(2) Level Contribution to Surplus per $1,000 Face Amount at 2.4668%*	(5) = (1)/(3) Level Contribution to Surplus per $1,000 Face Amount at 5.4668%*
1 - 3	7.0	$ 3.2	$21.3	$2.19**	$0.33**
4 - 8	9.0	4.2	24.0	2.14**	0.37**
9 - 13	11.4	5.4	26.9	2.11**	0.42**
14 - 18	14.0	7.0	30.0	2.00**	0.47**
19 - 23	16.9	8.9	33.3	1.90**	0.51**
24 - 28	19.5	11.2	36.5	1.75**	0.53**
29 - 33	21.1	13.9	39.5	1.52**	0.53**
34 - 38	21.2	16.8	42.0	1.26**	0.50**
39 - 43	20.7	19.8	43.6	1.05	0.47
44 - 48	20.6	22.4	43.7	0.92	0.47
49 - 53	17.6	24.3	42.1	0.72	0.42
54 - 58	14.1	25.0	38.6	0.56	0.37

*Face amount is accumulated at after-tax interest rates, with and without the equity tax, which is estimated as 3%:

$2.4668\% = 8.65\% [1 - 46\%(80\%)] - 3\%$

$5.4668\% = 8.65\% [1 - 46\%(80\%)]$

**Contracts issued before year 39 received lower dividends (in years at lest through year 40) than other contracts (issued in later years) received at comparable durations since issue date.

TABLE H

TERMINATORS' CONTRIBUTIONS TO SURPLUS AS OF DATE OF DEMUTUALIZATION IN RELATION TO GROSS INCOME

(8% Growth Company)

Issue Year	(1) Terminators' Surplus on Date of Demutualization ($ Millions)	(2) Value of Terminators' Gross Income Accumulated at 2.4668%* ($ Millions)	(3) Value of Terminators' Gross Income Accumulated at 5.4668%* ($ Millions)	(4) = (1)/(2) Contribution to Surplus as a Percentage of Gross Income at 2.4668%*	(5) = (1)/(3) Contribution to Surplus as a Percentage of Gross Income at 5.4668%*
1 – 3	7.0	151.6	808.5	4.6%**	0.9%**
4 – 8	9.0	192.5	905.4	4.7 **	1.0 **
9 – 13	11.4	243.1	1,009.2	4.7 **	1.1 **
14 – 18	14.0	304.3	1,118.0	4.6 **	1.3 **
19 – 23	16.9	377.6	1,230.4	4.5 **	1.4 **
24 – 28	19.5	461.9	1,338.0	4.2 **	1.5 **
29 – 33	21.1	551.6	1,426.0	3.8 **	1.5 **
34 – 38	21.2	642.0	1,484.8	3.3 **	1.4 **
39 – 43	20.7	725.7	1,503.5	2.9 **	1.4
44 – 48	20.6	788.1	1,466.9	2.6	1.4
49 – 53	17.6	804.8	1,351.7	2.2	1.3
54 – 58	14.1	772.2	1,172.4	1.8	1.2

*Gross income is accumulated at after-tax interest rates, with and without the equity tax, which is estimated as 3%:

2.4668% = 8.65% [1 − 46%(80%)] − 3%

5.4668% = 8.65% [1 − 46%(80%)]

**Contracts issued before year 39 received lower dividends (in years at least through year 40) than other contracts (issued in later years) received at comparable durations since issue date.

TABLE I (Summary)

CLOSED BRANCH CASH FLOWS
(8% Growth Before Conversion Date)
($ Millions)

Year	(1) Insurance Cash Outflow = Benefits + Expenses + Cash Dividends + Federal Income Tax + Increase in Policy Loans − Policy Loan Interest − Premiums	Investment Cash Inflows from Non-Policy Loan Assets (Including Reinvestments)		(4) = (2) + (3) − (1) Net Cash Inflow
		(2) Maturities	(3) Investment Income	
1	− 17.0	60.3	114.1	191.5
2	23.4	162.6	123.8	263.0
3	46.6	85.2	131.5	170.1
4	66.8	107.5	138.0	178.6
5	84.5	103.6	143.4	162.5
6	100.1	90.5	147.8	138.2
7	112.3	245.2	151.4	284.3
8	123.9	129.8	154.3	160.3
9	135.1	152.1	156.5	173.4
10	145.5	174.4	157.9	186.8
11–15	840.2	965.7	786.7	912.2
16–20	933.2	943.1	731.8	741.6
21–25	914.3	912.2	628.6	626.5
26–30	813.0	741.6	503.1	431.7
31–35	668.0	626.5	377.3	335.9
36–45	880.1	767.6	440.3	327.8
46–55	392.6	327.7	165.7	100.8
56–65	124.7	100.8	41.0	17.1
66–75	22.1	17.1	5.0	0.0

TABLE I (DETAIL)

CLOSED BRANCH PROJECTION
(8% Growth Historically)

($ Millions)

	Years					
	0	1	2	3	4	5
Cash Flow of Investments						
1. Non-policy Loan Interest	—	114.1	123.8	131.5	138.0	143.4
2. Non-policy Loan Investment Maturities	—	60.3	162.6	85.2	107.5	103.6
3. Cash Flow of Investments = 1 + 2	—	174.4	286.4	216.7	245.4	247.0
Cash Flow of Insurance						
4. Premium	—	426.5	391.8	362.7	337.4	315.1
5. Policy Loan Interest	—	36.5	39.2	41.6	43.6	45.2
6. Benefits (Death, Surrender, Endowment)	—	212.1	224.2	234.3	241.1	246.2
7. Expenses (Commission, Agency, Administrative and Premium Tax)	—	68.8	62.4	57.4	52.9	48.8
8. Cash Dividends	—	116.9	126.2	127.7	128.7	129.0
9. Federal Income Tax	—	7.0	2.6	- 0.5	- 1.3	- 0.6
10. Increase in Policy Loans	—	41.2	38.9	31.9	26.4	21.4
11. Cash Flow of Insurance = 4 + 5 − (6 + 7 + 8 + 9 + 10)	—	17.0	- 23.4	- 46.6	- 66.8	- 84.5
12. Total Cash Flow (Investments and Insurance) = 3 + 11	—	191.5	263.0	170.1	178.6	162.5
Statutory Accrual Items						
1. Increase in Statutory Reserves	—	172.6	139.5	113.4	92.0	73.6
2. Increase in Dividend Liability	—	9.4	1.5	0.9	0.4	- 0.2
Statutory Balance Sheet at the End of the Period						
1. Non-policy Loan Assets	1,311.2	1,442.4	1,542.8	1,627.7	1,698.8	1,757.7
2. Policy Loan Assets	519.4	560.6	599.5	631.4	657.9	679.3
3. Statutory Reserve	2,334.1	2,506.7	2,646.2	2,759.6	2,851.6	2,925.3
4. Dividend Liability	116.8	126.2	127.7	128.7	129.0	128.8
5. Net of 1 + 2 − (3 + 4)	- 620.3	- 630.0	- 631.7	- 629.2	- 624.0	- 617.1
Tax Information						
1. Increase in Tax Reserves	—	160.3	134.8	117.7	99.8	81.3
2. Tax Reserves at the End of the Period	2,159.7	2,320.0	2,454.7	2,572.4	2,672.2	2,753.5

TABLE I (DETAIL) — *Continued*

	Years					
	6	7	8	9	10	11-15
Cash Flow of Investments						
1. Non-policy Loan Interest	147.8	151.4	154.3	156.5	157.9	786.7
2. Non-policy Loan Investment Maturities	90.5	245.2	129.8	152.1	174.4	965.7
3. Cash Flow of Invesments = 1 + 2	238.3	396.6	284.1	308.5	332.3	1,752.4
Cash Flow of Insurance						
4. Premium	295.1	277.0	260.3	244.7	230.1	955.9
5. Policy Loan Interest	46.5	47.6	48.3	48.9	49.2	243.8
6. Benefits (Death, Surrender, Endowment)	250.5	252.3	254.7	257.2	259.5	1,311.8
7. Expenses (Commission, Agency, Administrative and Premium Tax)	45.2	41.8	38.5	37.1	35.9	161.4
8. Cash Dividends	128.9	128.2	127.1	125.4	123.2	572.3
9. Federal Income Tax	0.1	1.3	2.3	2.5	3.0	22.2
10. Increase in Policy Loans	17.0	13.3	9.9	6.5	3.3	– 27.8
11. Cash Flow of Insurance = 4 + 5 – (6 + 7 + 8 + 9 + 10)	– 100.1	– 112.3	– 123.9	– 135.1	– 145.5	– 840.2
12. Total Cash Flow (Investments and Insurance) = 3 + 11	138.2	284.3	160.3	173.4	186.8	912.2
Statutory Accrual Items						
1. Increase in Statutory Reserves	57.0	43.4	29.6	16.4	3.7	– 150.4
2. Increase in Dividend Liability	– 0.7	– 1.1	– 1.6	– 2.2	– 2.7	– 15.9
Statutory Balance Sheet at the End of the Period						
1. Non-policy Loan Assets	1,805.4	1,844.5	1,875.0	1,896.4	1,908.8	1,855.3
2. Policy Loan Assets	696.3	709.6	719.5	725.9	729.2	701.4
3. Statutory Reserve	2,982.2	3,025.7	3,055.3	3,071.7	3,075.3	2,924.9
4. Dividend Liability	128.2	127.0	125.4	123.2	120.5	104.5
5. Net of 1 + 2 – (3 + 4)	– 608.6	– 598.6	– 586.2	– 572.6	– 557.8	– 472.8
Tax Information						
1. Increase in Tax Reserves	64.6	50.1	36.4	23.6	10.5	– 119.5
2. Tax Reserves at the End of the Period	2,818.1	2,868.2	2,904.5	2,928.1	2,938.6	2,819.2

TABLE I (DETAIL) — *Continued*

	Years					
	16–20	21–25	26–30	31–35	36–40	41–45
Cash Flow of Investments						
1. Non-policy Loan Interest	731.8	628.6	503.1	377.3	265.9	174.4
2. Non-policy Loan Investment Maturities	943.1	912.2	741.6	626.5	431.7	335.9
3. Cash Flow of Investments = 1 + 2	1,674.9	1,540.9	1,244.7	1,003.8	691.7	510.2
Cash Flow of Insurance						
4. Premium	681.0	464.1	300.5	184.7	108.1	59.6
5. Policy Loan Interest	224.3	190.0	149.7	110.5	76.7	49.6
6. Benefits (Death, Surrender, Endowment)	1,270.4	1,148.4	967.3	764.7	570.1	404.3
7. Expenses (Commission, Agency, Administrative and Premium Tax)	134.3	109.6	87.4	67.8	51.1	36.7
8. Cash Dividends	485.4	389.1	297.7	217.3	150.6	97.5
9. Federal Income Tax	32.4	35.7	31.1	22.7	15.1	9.0
10. Increase in Policy Loans	− 83.9	− 114.4	− 120.2	− 109.4	− 90.4	− 69.8
11. Cash Flow of Insurance = 4 + 5 − (6 + 7 + 8 + 9 + 10)	− 933.2	− 914.3	− 813.0	− 668.0	−511.6	−368.5
12. Total Cash Flow (Investments and Insurance) = 3 + 11	741.6	626.5	431.7	335.9	186.0	141.7
Statutory Accrual Items						
1. Increase in Statutory Reserves	− 366.6	− 482.3	− 502.1	− 453.5	−372.5	−286.5
2. Increase in Dividend Liability	− 19.0	− 18.9	− 17.0	− 14.5	− 11.7	− 9.0
Statutory Balance Sheet at the End of the Period						
1. Non-policy Loan Assets	1,653.8	1,368.1	1,058.2	767.6	521.9	327.7
2. Policy Loan Assets	617.5	503.1	382.9	273.5	183.1	113.3
3. Statutory Reserve	2,558.3	2,076.0	1,573.9	1,120.4	747.9	461.4
4. Dividend Liability	85.5	66.6	49.6	35.0	23.4	14.3
5. Net of 1 + 2 − (3 + 4)	− 372.5	− 271.4	− 182.4	− 114.3	− 66.2	− 34.7
Tax Information						
1. Increase in Tax Reserves	− 341.0	− 461.4	− 483.4	− 439.0	−362.0	−279.4
2. Tax Reserves at the End of the Period	2,478.2	2,016.8	1,533.3	1,094.4	732.3	452.9

TABLE I (DETAIL) — *Continued*

	Years					
	46–50	51–55	56–60	61–65	66–70	71–75
Cash Flow of Investments						
1. Non-policy Loan Interest	106.2	59.5	29.0	12.0	4.2	0.8
2. Non-policy Loan Investment Maturities	186.0	141.7	50.7	50.1	− 6.3	23.4
3. Cash Flow of Investments = 1 + 2	292.2	201.2	79.7	62.1	− 2.1	24.2
Cash Flow of Insurance						
4. Premium	31.3	15.3	6.6	2.5	0.8	0.1
5. Policy Loan Interest	29.7	16.5	7.9	3.3	1.1	0.2
6. Benefits (Death, Surrender, Endowment)	261.9	163.6	94.0	42.9	18.4	6.5
7. Expenses (Commission, Agency, Administrative and Premium Tax)	25.1	16.0	9.0	4.4	1.7	0.4
8. Cash Dividends	58.6	32.9	16.1	6.6	2.4	0.6
9. Federal Income Tax	4.7	2.2	0.7	− 0.4	− 0.1	0.0
10. Increase in Policy Loans	− 47.7	− 31.6	− 19.3	− 9.0	− 4.1	− 1.5
11. Cash Flow of Insurance = 4 + 5 − (6 + 7 + 8 + 9 + 10)	−241.5	−151.1	− 86.0	− 38.7	− 16.6	− 5.5
12. Total Cash Flow (Investments and Insurance) = 3 + 11	50.7	50.1	− 6.3	23.4	− 18.7	18.7
Statutory Accrual Items						
1. Increase in Statutory Reserves	−195.1	−128.8	− 78.2	− 36.6	− 16.5	− 6.2
2. Increase in Dividend Liability	− 6.0	− 4.0	− 2.5	− 1.1	− 0.5	− 0.2
Statutory Balance Sheet at the End of the Period						
1. Non-policy Loan Assets	192.4	100.8	43.8	17.1	4.7	0.0
2. Policy Loan Assets	65.6	33.9	14.7	5.6	1.5	0.0
3. Statutory Reserve	266.3	137.4	59.3	22.7	6.2	0.0
4. Dividend Liability	8.3	4.3	1.9	0.7	0.2	0.0
5. Net of 1 + 2 − (3 + 4)	− 16.6	− 7.1	− 2.7	− 0.7	− 0.2	0.0
Tax Information						
1. Increase in Tax Reserves	−191.1	−126.9	− 77.4	− 35.0	− 16.3	− 6.2
2. Tax Reserves at the End of the Period	261.8	134.9	57.5	22.5	6.2	0.0

TABLE J

ASSETS ACCUMULATED VERSUS ASSETS NEEDED ON CONTRACTS IN FORCE
(8% Growth Company)

Issue Year	(1) Assets Accumulated by Contracts In Force ($ Millions)	(2) Assets Needed for Closed Branch ($ Millions)	(3) Excess Assets (Accumulated over Needed) ($ Millions)	(4) Face Amount In Force ($ Millions)	(5) = $\frac{1,000(3)}{(4)}$ Excess Assets per $1,000 Face Amount In Force	Cash Value In Force ($ Millions)	(7) = $\frac{100(3)}{(6)}$ Ratio of Excess Assets to Cash Value In Force
1 – 3	0.02	0.01	0.01	0.01	$793	0.01	79%
4 – 8	0.10	0.10	0.05	0.10	669	0.10	74
9 – 13	0.40	0.30	0.17	0.30	573	0.30	67
14 – 18	1.40	0.90	0.50	1.00	478	0.90	58
19 – 23	3.70	2.40	1.30	3.00	408	2.50	53
24 – 28	8.80	5.90	2.90	8.00	345	6.00	48
29 – 33	19.70	13.60	6.10	21.00	288	14.10	43
34 – 38	40.10	28.60	11.50	49.00	233	30.20	38
39 – 43	76.20	56.10	20.10	109.00	184	59.90	34
44 – 48	136.60	103.80	32.80	233.00	141	112.40	29
49 – 53	226.00	177.70	48.30	478.00	101	195.00	25
54 – 58	341.70	277.20	64.60	944.00	68	307.70	21
59 – 63	465.10	384.70	80.40	1,811.00	44	429.90	19
64	104.40	86.60	17.80	532.00	33	97.30	18
65	106.90	88.80	18.10	608.00	30	100.10	18
66	108.70	89.80	18.90	694.00	27	101.60	19
67	109.70	89.90	19.80	797.00	25	102.00	19
68	108.30	88.50	19.80	917.00	22	101.40	20
69	106.30	86.00	20.30	1,062.00	19	98.60	21
70	102.40	81.30	21.10	1,241.00	17	93.10	23
71	94.30	73.20	21.10	1,461.00	14	84.70	25
72	82.10	60.60	21.50	1,734.00	12	70.20	31
73	65.10	42.60	22.50	2,086.00	11	50.20	45
74	52.90	16.90	36.00	2,565.00	14	19.20	187
75	– 7.50	– 24.90	17.30	3,467.00	5	0.00	—
Total	2,353.40	1,830.60	522.90	20,821.00	$ 25	2,077.40	25%

TABLE AA

MODEL COMPANY SUMMARY OF OPERATIONS
(5% Growth Company)
($ Millions)

	Years							
	1–10	11–20	21–30	31–40	41–50	51–60	61–70	71–75 (five years only)
Premium Income	$13.6	$32.4	$58.3	$97.5	$159.8	$260.6	$441.5	$306.7
Net Investment Income*	2.0	10.0	24.6	47.8	83.9	139.3	228.2	162.8
Death Benefits	1.3	5.2	13.1	25.6	44.7	74.3	122.3	87.2
Surrender and Endowment Benefits	1.4	5.9	13.3	24.3	41.2	67.7	110.9	78.9
Increase in Reserves	6.5	13.9	21.4	31.7	48.7	77.7	129.7	90.1
Commission and Agency Expense	3.8	6.8	11.4	18.8	30.7	49.9	94.5	61.7
Administrative Expense	1.2	2.9	5.4	9.4	15.7	25.8	44.9	30.8
Cash Dividends Paid	1.5	6.0	12.9	23.0	40.0	72.0	117.7	84.4
Increase in Dividend Liabilities	0.3	0.6	0.8	1.2	3.7	4.3	4.4	4.1
Federal Income Tax	0.3	1.2	3.4	7.8	14.7	22.6	36.0	25.9
Net Gain	(0.7)	(0.1)	1.2	3.5	4.3	5.6	9.3	6.4

*Interest earned on assets corresponding to surplus note is offset by interest paid on surplus note, which is charged against this Net Investment Income line.

TABLE BB

MODEL COMPANY BALANCE SHEET
(5% Growth Company)
($ Millions)

	End of Year							
	5	15	25	35	45	55	65	75
Assets								
Non-policy Loans	$2.1	$11.2	$26.5	$49.3	$ 84.0	$139.8	$231.4	$373.4
Policy Loans	0.5	2.8	6.9	12.8	21.9	36.1	59.2	95.4
Total	2.6	14.0	33.4	62.1	105.9	175.9	290.6	468.8
Liabilities								
Reserves	2.3	12.5	30.0	56.0	95.1	156.4	260.0	419.7
Dividend Liability	0.1	0.6	1.3	2.2	4.2	8.5	12.4	19.4
Federal Income Tax Liability	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3
Total	2.4	13.1	31.3	58.2	99.3	164.9	272.4	439.4
Surplus Note	0.5	1.7	2.5	2.0	0.0	0.0	0.0	0.0
Unassigned Surplus	(0.3)	(0.8)	(0.4)	1.9	6.6	11.0	18.2	29.4

TABLE CC

Modifications to Dividend Scale
(5% Growth Company)

Year	Dividend Paid ($ Millions)	Standard Dividend ($ Millions)	Ratio
41 – 45	16.9	16.9	100%
46 – 50	23.1	21.7	107
51 – 55	31.5	27.8	113
56 – 60	40.5	35.5	114
61 – 65	50.7	45.3	112
66 – 70	67.0	57.7	116
71 – 75	84.4	73.5	115

TABLE DD

Face Amount of Insurance as of Conversion Date
(5% Growth Company)
($ Millions)

Issue Year	(1) Total Issued	In Force on Conversion Date		(4) = (1) – (2) Terminated Prior to Conversion
		(2) Amount	(3) Cumulative Distribution	
1 – 3	55	0.01	100%	55
4 – 8	71	0.06	100	71
9 – 13	90	0.20	100	90
14 – 18	115	0.70	100	114
19 – 23	147	2.00	100	145
24 – 28	187	4.00	100	183
29 – 33	239	9.00	100	230
34 – 38	305	17.00	99	288
39 – 43	389	33.00	99	356
44 – 48	496	62.00	98	434
49 – 53	634	110.00	96	524
54 – 58	809	189.00	92	620
59 – 63	1,032	315.00	86	717
64	238	85.00	75	153
65	250	95.00	72	155
66	263	105.00	69	158
67	276	117.00	66	159
68	290	131.00	62	159
69	304	148.00	57	156
70	319	168.00	52	151
71	335	192.00	47	143
72	352	222.00	40	130
73	370	259.00	33	111
74	388	310.00	24	78
75	408	408.00	14	0
Total	8,362 (100%)	2,982.00 (36%)		5,380 (64%)

TABLE EE

ASSETS, LIABILITIES, AND SURPLUS AT CONVERSION BY ISSUE YEAR
(5% Growth Company)
($ Millions)

Issue Year	Assets Accumulated by			Reserves and Liabilities In Force	Surplus Accumulated by		
	Contracts In Force	Terminated Contracts	All Contracts		Contracts In Force	Terminated Contracts	All Contracts
1 - 3	0.02	3.7	3.7	0.02	0.00	3.7	3.7
4 - 8	0.10	4.2	4.3	0.06	0.02	4.2	4.2
9 - 13	0.30	4.7	5.0	0.20	0.10	4.7	4.8
14 - 18	0.70	5.3	6.0	0.60	0.10	5.3	5.4
19 - 23	1.70	5.7	7.4	1.40	0.30	5.7	6.0
24 - 28	3.50	6.0	9.5	3.00	0.50	6.0	6.5
29 - 33	6.90	5.9	12.8	6.00	0.90	5.9	6.8
34 - 38	12.50	5.5	18.0	11.20	1.30	5.5	6.8
39 - 43	20.90	4.6	25.5	19.40	1.50	4.6	6.1
44 - 48	32.80	3.7	36.5	31.80	1.00	3.7	4.7
49 - 53	47.90	3.1	51.0	48.30	- 0.40	3.1	2.7
54 - 58	63.70	2.8	66.5	66.70	- 3.00	2.8	- 0.2
59 - 63	76.30	2.6	78.9	82.90	- 6.60	2.6	- 4.0
64	15.90	0.5	16.4	17.70	- 1.80	0.5	- 1.3
65	15.90	0.4	16.3	17.80	- 1.90	0.4	- 1.5
66	15.80	0.4	16.2	17.90	- 2.10	0.4	- 1.7
67	15.50	0.4	15.9	17.80	- 2.30	0.4	- 1.9
68	14.90	0.4	15.3	17.30	- 2.40	0.4	- 2.0
69	14.20	0.4	14.6	16.70	- 2.50	0.4	- 2.1
70	13.30	0.3	13.6	15.90	- 2.60	0.3	- 2.3
71	12.00	0.2	12.2	14.60	- 2.60	0.2	- 2.4
72	10.00	0.2	10.2	12.70	- 2.70	0.2	- 2.5
73	7.70	0.1	7.8	10.30	- 2.60	0.1	- 2.5
74	6.50	- 0.1	6.4	8.70	- 2.20	- 0.1	- 2.3
75	- 1.20	—	- 1.2	0.40	- 1.60	—	1.6
Total	407.80 (87%)	61.0 (13%)	468.8 (100%)	439.40	-31.60	61.0	29.4

TABLE FF

TERMINATORS' CONTRIBUTIONS TO SURPLUS AS OF DATE OF DEMUTUALIZATION IN RELATION TO PREMIUM

(5% Growth Company)

Issue Year	(1) Terminators' Surplus on Date of Demutualization ($ Millions)	(2) Value of Terminators' Premium Accumulated at 2.056%* ($ Millions)	(3) Value of Terminators' Premium Accumulated at 5.056%* ($ Millions)	(4) = (1)/(2) Contribution to Surplus as a Percentage of Premium at 2.056%*	(5) = (1)/(3) Contribution to Surplus as a Percentage of Premium at 5.056%*
1 - 3	3.7	53.3	360.0	6.9%	1.0%
4 - 8	4.2	61.4	358.7	6.8	1.2
9 - 13	4.7	70.6	357.0	6.7	1.3
14 - 18	5.3	80.8	354.2	6.6	1.5
19 - 23	5.7	91.9	349.8	6.2	1.6
24 - 28	6.0	103.6	343.2	5.8	1.7
29 - 33	5.9	114.8	332.0	5.1	1.8
34 - 38	5.5	124.7	315.7	4.4	1.7
39 - 43	4.6	131.2	292.3	3.5	1.6
44 - 48	3.7	132.0	260.3	2.8	1.4
49 - 53	3.1	126.3	221.2	2.5	1.4
54 - 58	2.8	113.9	177.9	2.5	1.6

*Premium is accumulated at after-tax interest rates, with and without the equity tax, which is estimated as 3%:

2.056% = 8% [1 - 46% (80%)] - 3%
5.056% = 8% [1 - 46% (80%)]

TABLE GG

TERMINATORS' CONTRIBUTIONS TO SURPLUS AS OF DATE OF DEMUTUALIZATION IN RELATION TO FACE AMOUNTS

(5% Growth Company)

Issue Year	(1) Terminators' Surplus on Date of Demutualization ($ Millions)	(2) Value of Face Amounts (in Billions) Exposed per Year by Terminators Accumulated at 2.056%*	(3) Value of Face Amounts (in Billions) Exposed per Year by Terminators Accumulated at 5.056%*	(4) = (1)/(2) Level Contribution to Surplus per $1,000 Face Amount at 2.056%*	(5) = (1)/(3) Level Contribution to Surplus per $1,000 Face Amount at 5.056%*
1 – 3	3.7	$2.4	$15.5	$1.54	$0.24
4 – 8	4.2	2.7	15.4	1.56	0.27
9 – 13	4.7	3.1	15.3	1.52	0.31
14 – 18	5.3	3.5	15.2	1.51	0.35
19 – 23	5.7	4.0	14.9	1.42	0.38
24 – 28	6.0	4.5	14.5	1.33	0.41
29 – 33	5.9	4.9	13.8	1.20	0.43
34 – 38	5.5	5.2	13.0	1.06	0.42
39 – 43	4.6	5.4	11.9	0.85	0.39
44 – 48	3.7	5.4	10.6	0.69	0.35
49 – 53	3.1	5.2	9.0	0.60	0.34
54 – 58	2.8	4.7	7.3	0.60	0.38

*Face amount is accumulated at after-tax interest rates, with and without the equity tax, which is estimated as 3%:

2.056% = 8% [1 − 46%(80%)] − 3%

5.056% = 8% [1 − 46%(80%)]

TABLE HH

TERMINATORS' CONTRIBUTIONS TO SURPLUS AS OF DATE OF DEMUTUALIZATION IN RELATION TO GROSS INCOME
(5% Growth Company)

Issue Year	(1) Terminators' Surplus on Date of Demutualization ($ Millions)	(2) Value of Terminators' Gross Income Accumulated at 2.056%* ($ Millions)	(3) Value of Terminators' Gross Income Accumulated at 5.056%* ($ Millions)	(4) = (1)/(2) Contribution to Surplus as a Percentage of Gross Income at 2.056%*	(5) = (1)/(3) Contribution to Surplus as a Percentage of Gross Income at 5.056%*
1 – 3	3.7	101.0	559.2	3.7%	0.7%
4 – 8	4.2	114.4	555.2	3.7	0.8
9 – 13	4.7	129.0	550.0	3.6	0.9
14 – 18	5.3	144.3	541.3	3.7	1.0
19 – 23	5.7	160.0	529.3	3.6	1.1
24 – 28	6.0	174.8	511.8	3.4	1.2
29 – 33	5.9	186.6	485.5	3.2	1.2
34 – 38	5.5	193.9	450.1	2.8	1.2
39 – 43	4.6	194.2	403.7	2.4	1.1
44 – 48	3.7	185.4	346.3	2.0	1.1
49 – 53	3.1	168.0	282.9	1.8	1.1
54 – 58	2.8	143.1	217.6	2.0	1.3

*Gross income is accumulated at after-tax interest rates, with and without the equity tax, which is estimated as 3%:

2.056% = 8% [1 − 46%(80%)] − 3%

5.056% = 8% [1 − 46%(80%)]

TABLE II (Summary)

CLOSED BRANCH CASH FLOWS
(5% Growth Before Conversion Date)
($ Millions)

Year	(1) Insurance Cash Outflow = Benefits + Expenses + Cash Dividends + Federal Income Tax + Increase in Policy Loans − Policy Loan Interest − Premiums	Investment Cash Inflows from Non-Policy Loan Assets (Including Reinvestments)		(4) = (2) + (3) − (1) Net Cash Inflow
		(2) Maturities	(3) Investment Income	
1	6.2	11.5	21.1	26.4
2	11.1	40.9	22.1	51.9
3	14.1	16.9	22.9	25.7
4	16.6	23.2	23.5	30.1
5	18.8	20.0	24.0	25.2
6	20.9	21.1	24.3	24.6
7	22.2	54.3	24.5	56.6
8	23.5	21.6	24.7	22.8
9	24.8	28.0	24.7	27.9
10	26.0	29.6	24.6	28.2
11–15	141.6	159.3	119.3	136.9
16–20	147.6	160.1	106.9	119.3
21–25	138.8	136.9	89.2	87.3
26–30	119.9	119.3	69.7	69.1
31–35	96.4	87.3	51.2	42.1
36–45	123.6	111.2	58.2	45.8
46–55	53.4	45.8	21.2	13.5
56–65	16.4	13.6	5.1	2.3
66–75	2.8	2.2	0.6	0.0

TABLE II (DETAIL)

CLOSED BRANCH PROJECTION
(5% Growth Historically)
($ Millions)

	Years					
	0	1	2	3	4	5
Cash Flow of Investments						
1. Non-policy Loan Interest	—	21.1	22.1	22.9	23.5	24.0
2. Non-policy Loan Investment Maturities	—	11.5	40.9	16.9	23.2	20.0
3. Cash Flow of Investments = 1 + 2	—	32.6	63.0	39.8	46.7	44.0
Cash Flow of Insurance						
4. Premium	—	61.0	56.2	52.1	48.5	45.3
5. Policy Loan Interest	—	6.6	6.9	7.2	7.4	7.5
6. Benefits (Death, Surrender, Endowment)	—	38.3	39.4	40.5	41.2	41.7
7. Expenses (Commission, Agency, Administrative and Premium Tax)	—	10.6	9.7	9.0	8.4	7.8
8. Cash Dividends	—	19.4	20.4	20.4	20.4	20.3
9. Federal Income Tax	—	0.9	0.4	0.0	- 0.2	- 0.1
10. Increase in Policy Loans	—	4.7	4.3	3.4	2.6	2.0
11. Cash Flow of Insurance = 4 + 5 − (6 + 7 + 8 + 9 + 10)	—	- 6.2	- 11.1	- 14.1	- 16.6	- 18.8
12. Total Cash Flow (Investments and Insurance) = 3 + 11	—	26.4	51.9	25.7	30.1	25.2
Statutory Accrual Items						
1. Increase in Statutory Reserves	—	19.2	15.0	11.5	8.6	6.0
2. Increase in Dividend Liability	—	1.0	0.0	0.0	- 0.1	- 0.2
Statutory Balance Sheet at the End of the Period						
1. Non-policy Loan Assets	267.2	282.1	293.1	301.9	308.8	314.0
2. Policy Loan Assets	95.4	100.1	104.4	107.8	110.5	112.4
3. Statutory Reserve	419.8	439.0	454.0	465.5	474.0	480.1
4. Dividend Liability	19.4	20.4	20.4	20.4	20.3	20.1
5. Net of 1 + 2 − (3 + 4)	- 76.6	- 77.1	- 76.9	- 76.1	- 75.0	- 73.8
Tax Information						
1. Increase in Tax Reserves	—	18.1	14.7	12.3	9.8	7.2
2. Tax Reserves at the End of the Period	392.6	410.7	425.3	437.6	447.4	454.7

TABLE II (DETAIL) — *Continued*

	Years					
	6	7	8	9	10	11-15
Cash Flow of Investments						
1. Non-policy Loan Interest	24.3	24.5	24.7	24.7	24.6	119.3
2. Non-policy Loan Investment Maturities	21.1	54.3	21.6	28.0	29.6	159.3
3. Cash Flow of Investments = 1 + 2	45.4	78.8	46.3	52.7	54.3	278.5
Cash Flow of Insurance						
4. Premium	42.4	39.8	37.3	35.0	32.9	135.6
5. Policy Loan Interest	7.7	7.7	7.8	7.8	7.8	37.5
6. Benefits (Death, Surrender, Endowment)	42.2	42.0	42.0	42.1	42.1	208.1
7. Expenses (Commission, Agency, Administrative and Premium Tax)	7.3	6.9	6.4	6.2	6.0	26.9
8. Cash Dividends	20.1	19.8	19.5	19.2	18.7	85.8
9. Federal Income Tax	0.0	0.1	0.2	0.2	0.3	2.2
10. Increase in Policy Loans	1.3	0.8	0.4	− 0.1	− 0.5	− 8.4
11. Cash Flow of Insurance = 4 + 5 − (6 + 7 + 8 + 9 + 10)	−20.9	−22.2	−23.5	−24.8	−26.0	−141.6
12. Total Cash Flow (Investments and Insurance) = 3 + 11	24.6	56.6	22.8	27.9	28.2	136.9
Statutory Accrual Items						
1. Increase in Statutory Reserves	3.6	1.9	0.0	− 1.8	− 3.5	− 39.2
2. Increase in Dividend Liability	− 0.3	− 0.3	− 0.4	− 0.4	− 0.5	− 2.8
Statutory Balance Sheet at the End of the Period						
1. Non-policy Loan Assets	317.4	319.7	320.9	320.7	319.3	297.0
2. Policy Loan Assets	113.7	114.6	115.0	114.9	114.4	106.0
3. Statutory Reserve	483.6	485.5	485.6	483.8	480.4	441.1
4. Dividend Liability	19.8	19.5	19.2	18.7	18.2	15.5
5. Net of 1 + 2 − (3 + 4)	− 72.3	−70.8	−68.9	−67.0	−64.9	− 53.6
Tax Information						
1. Increase in Tax Reserves	4.7	2.9	1.1	− 0.6	− 2.4	− 34.5
2. Tax Reserves at the End of the Period	459.4	462.4	463.4	462.8	460.4	425.8

TABLE II (DETAIL) — *Continued*

	Years					
	16–20	21–25	26–30	31–35	36–40	41–45
Cash Flow of Investments						
1. Non-policy Loan Interest	106.9	89.2	69.7	51.2	35.4	22.8
2. Non-policy Loan Investment Maturities	160.1	136.9	119.3	87.3	69.1	42.1
3. Cash Flow of Investments = 1 + 2	266.9	226.1	189.0	138.5	104.5	64.9
Cash Flow of Insurance						
4. Premium	95.5	64.3	41.2	25.1	14.5	7.9
5. Policy Loan Interest	33.4	27.6	21.3	15.5	10.6	6.7
6. Benefits (Death, Surrender, Endowment)	194.8	171.2	141.0	109.5	80.3	55.9
7. Expenses (Commission, Agency, Administrative and Premium Tax)	22.4	18.2	14.5	11.2	8.3	5.9
8. Cash Dividends	71.3	56.2	42.3	30.4	20.8	13.2
9. Federal Income Tax	3.3	3.5	2.9	1.9	1.1	0.5
10. Increase in Policy Loans	− 15.2	− 18.4	− 18.3	− 16.1	− 13.0	− 9.8
11. Cash Flow of Insurance = 4 + 5 − (6 + 7 + 8 + 9 + 10)	−147.6	−138.8	−119.9	− 96.4	− 72.4	−51.2
12. Total Cash Flow (Investments and Insurance) = 3 + 11	119.3	87.3	69.1	42.1	32.1	13.7
Statutory Accrual Items						
1. Increase in Statutory Reserves	− 65.5	− 77.2	− 76.2	− 66.6	− 53.3	−40.0
2. Increase in Dividend Liability	− 3.0	− 2.9	− 2.5	− 2.1	− 1.7	− 1.3
Statutory Balance Sheet at the End of the Period						
1. Non-policy Loan Assets	256.2	206.6	156.4	111.2	74.2	45.9
2. Policy Loan Assets	90.8	72.4	54.1	38.0	25.1	15.3
3. Statutory Reserve	375.7	298.4	222.3	155.6	102.3	62.3
4. Dividend Liability	12.4	9.5	7.0	4.9	3.2	1.9
5. Net of 1 + 2 − (3 + 4)	− 41.1	− 29.0	− 18.8	− 11.3	− 6.2	− 3.0
Tax Information						
1. Increase in Tax Reserves	− 61.6	− 74.1	− 73.5	− 64.6	− 51.9	−39.1
2. Tax Reserves at the End of the Period	364.2	290.2	216.7	152.1	100.2	61.1

TABLE II (DETAIL) — *Continued*

	Years					
	46–50	51–55	56–60	61–65	66–70	71–75
Cash Flow of Investments						
1. Non-policy Loan Interest	13.6	7.5	3.6	1.5	0.5	0.1
2. Non-policy Loan Investment Maturities	32.1	13.7	12.7	0.9	4.9	-2.7
3. Cash Flow of Investments = 1 + 2	45.8	21.2	16.2	2.4	5.4	2.6
Cash Flow of Insurance						
4. Premium	4.1	2.0	0.8	0.3	0.1	0.0
5. Policy Loan Interest	4.0	2.2	1.0	0.4	0.1	0.0
6. Benefits (Death, Surrender, Endowment)	35.8	21.9	12.3	5.6	2.3	0.8
7. Expenses (Commission, Agency, Administrative and Premium Tax)	4.0	2.5	1.4	0.7	0.3	0.1
8. Cash Dividends	7.8	4.3	2.1	0.8	0.3	0.1
9. Federal Income Tax	0.2	0.0	-0.1	-0.1	0.0	0.0
10. Increase in Policy Loans	-6.6	-4.3	-2.5	-1.2	-0.5	-0.2
11. Cash Flow of Insurance = 4 + 5 − (6 + 7 + 8 + 9 + 10)	-33.1	-20.1	-11.3	-5.1	-2.1	-0.7
12. Total Cash Flow (Investments and Insurance) = 3 + 11	12.7	0.9	4.9	-2.7	3.3	-3.3
Statutory Accrual Items						
1. Increase in Statutory Reserves	-26.9	-17.4	-10.3	-4.8	-2.1	-0.8
2. Increase in Dividend Liability	-0.8	-0.5	-0.3	-0.1	-0.1	0.0
Statutory Balance Sheet at the End of the Period						
1. Non-policy Loan Assets	26.4	13.5	5.8	2.2	0.6	0.0
2. Policy Loan Assets	8.7	4.4	1.9	0.7	0.2	0.0
3. Statutory Reserve	35.3	17.9	7.6	2.9	0.8	0.0
4. Dividend Liability	1.1	0.6	0.2	0.1	0.0	0.0
5. Net of 1 + 2 − (3 + 4)	-1.3	-0.5	-0.2	0.0	0.0	0.0
Tax Information						
1. Increase in Tax Reserves	-26.4	-17.1	-10.2	-4.6	-2.1	-0.8
2. Tax Reserves at the End of the Period	34.7	17.6	7.4	2.8	0.8	0.0

TABLE JJ

ASSETS ACCUMULATED VERSUS ASSETS NEEDED ON CONTRACTS IN FORCE
(5% Growth Company)

Issue Year	(1) Assets Accumulated by Contracts In Force ($ Millions)	(2) Assets Needed for Closed Branch ($ Millions)	(3) Excess Assets (Accumulated over Needed) ($ Millions)	(4) Face Amount In Force ($ Millions)	$(5) = \frac{1{,}000\,(3)}{(4)}$ Excess Assets per $1,000 Face Amount In Force	Cash Value In Force ($ Millions)	(7) = 100(3)/(6) Ratio of Excess Assets to Cash Value In Force
1 - 3	0.02	0.01	0.004	0.01	$344	0.01	34%
4 - 8	0.10	0.10	0.020	0.06	282	0.05	31
9 - 13	0.30	0.20	0.050	0.20	259	0.20	30
14 - 18	0.70	0.60	0.150	0.70	224	0.60	27
19 - 23	1.70	1.30	0.400	2.00	205	1.30	27
24 - 28	3.50	2.80	0.700	4.00	180	2.90	25
29 - 33	6.90	5.60	1.300	9.00	145	5.80	23
34 - 38	12.50	10.30	2.200	17.00	127	10.90	21
39 - 43	20.90	17.70	3.200	33.00	96	18.30	18
44 - 48	32.80	28.50	4.300	62.00	70	29.80	14
49 - 53	47.90	42.50	5.400	110.00	49	44.90	12
54 - 58	63.70	57.80	5.900	189.00	31	61.50	10
59 - 63	76.30	70.30	6.000	315.00	19	74.70	8
64	14.90	14.70	1.200	85.00	14	15.60	8
65	15.90	14.70	1.200	95.00	13	15.60	8
66	15.80	14.50	1.300	105.00	12	15.40	8
67	15.50	14.20	1.300	117.00	11	15.00	9
68	14.90	13.70	1.200	131.00	9	14.50	9
69	14.20	13.00	1.200	148.00	8	13.70	9
70	13.30	12.10	1.200	168.00	7	12.60	9
71	12.00	10.80	1.200	192.00	6	11.10	11
72	10.00	9.00	1.000	222.00	5	9.00	12
73	7.70	6.50	1.200	259.00	5	6.20	19
74	6.50	3.30	3.200	310.00	10	2.30	137
75	- 1.20	- 1.60	0.400	408.00	1	0.00	—
Total	407.80	362.60	45.200	2,982.00	$ 15	382.00	12%

APPENDIX 2

MUTUAL COMPANY CAPITAL MANGEMENT

Most authoritative papers on mutual life insurance company financial operations have focused primarily on the considerations involved in maintaining equity among policyholders. Few have sought to discuss this subject in a manner which fully integrates the diverse financial operations of mutual life insurance companies.*

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*Some notable exceptions are: Leckie, *TSA* XXXI, and Trowbridge, *TSA* XIX.

In its work the Task Force needed to identify a financial model which could be considered to typify mutual company financial operations. It was understood in the selection of the typical model that it would not describe the financial operations of all mutual companies nor that it would describe the financial operations of each segment of those mutual companies which operated according to the typical model. We focused on accumulation and management of capital resources including, importantly, the interrelationship of this subject and policy pricing and dividends.

In our review we examined two general approaches to this subject: the entity capital approach in which participating policyholders make permanent contributions to the mutual company's surplus and the revolving fund approach in which policyholders do not make permanent contributions to surplus. (These approaches are described more fully later in this appendix.) This review involved principally an examination of the philosophies and operating practices of the companies represented on the Task Force. In addition, the Task Force tested its initial conclusions through the use of the model company described in Appendix 1.

The conclusion of our examination is that most mutual companies, in fact, employ the entity capital approach and that the changes in dividend scales that would be required to accommodate the revolving fund approach for the individual life insurance business are too severe to permit it to be used widely in today's competitive markets. Accordingly, the Task Force concluded that, for the purpose of developing the several methodologies required in a conversion action, we should assume mutual companies operate on the entity capital approach.

In the following sections we describe and analyze the entity capital model, which we believe represents the best descriptive model of overall mutual life insurance company financial operations. We then compare it to the revolving fund model. The final section presents some of the implications of the use of the entity capital approach for the several conversion elements.

MUTUAL LIFE INSURANCE COMPANY OBJECTIVES; IMPLICATIONS OF CURRENT ENVIRONMENT

The financial management of mutual life insurance companies involves many considerations common to the management of other businesses. In addition, there are some factors unique to mutual life companies.

Competition is a factor common to most businesses. It is an increasingly important element of the life insurance scene and comes from traditional and nontraditional products and competitors. To compete successfully, a company must be able to maintain a competitive pricing structure in its targeted market segments. The maintenance of a competitive pricing structure requires, in turn, the achievement of relatively low distribution expense levels, operating expense levels, and claims cost levels as well as superior investment return levels, or some combination of these. What is required to achieve relatively strong performance in any of these areas could be the subject of separate papers. It is sufficient here to point out that, over the long term, the achievement of superior results in these competitive areas, more often than not, will require large investments in technology, equipment, facilities, and staff upgrading and the growth required to achieve the necessary scale effects on distribution costs and investment opportunities.

A second general business factor is the recognition that maintaining an ability to serve customer needs often requires major changes in products, services, and marketing approaches, and the pace of these required changes is accelerating. For example, there was a time when low- to moderate-income life insurance customers could be served by professional agents on a one-on-one basis. This need is now met more often through group insurance or other mass distribution approaches. Companies will often find it necessary to serve old markets through new products, new lines of business, new distribution systems, or subsidiary companies or in other, different ways.

A third general consideration is that a life insurance company must accumulate sufficient capital to assure its ability to continue in operation and to meet its contract obligations. With the increased volatility of financial markets and increased competitiveness, the needs of financial institutions for retained capital are relatively greater today than they have traditionally been.

Like other businesses, mutual life insurance companies must be competitive, adaptable and conscious of the importance of capital in sustaining and supporting their financial operations. Although not mentioned as a separate factor, growth is an essential element of continued viability. Without sustained growth, it is almost impossible to reduce unit operating costs, to achieve distribution efficiencies, to achieve the scale necessary to participate in certain investment opportunities, or to serve existing markets through new products, new distribution channels, and so on. The Task Force believes strongly that profitable growth does serve the interests of mutual company policyholders.

The business considerations that are peculiar to mutual life insurance companies stem from their basic nature, that of mutual enterprises. The first of these considerations is that the enterprise must be operated in the interests of its members (policyholders). The second *is that the required capital base* must be accumulated almost entirely from capital charges made to policyholders.* A third consideration is the need to make each of the several types of charges and credits to policyholders (including the capital charges) in a way which preserves equity among and within the various policy classes.

DESCRIPTION OF THE ENTITY CAPITAL MODEL

The entity capital model is defined by three fundamental operating principles. The first principle is that the enterprise is a continuing entity whose capital base is considered to be the capital of the enterprise (not of individual policyholders or of the several lines) and is managed on an enterprise-wide basis. The second principle is that this capital is accumulated and deployed by the management and Board of Directors of the company in a manner that produces the best long-term financial result (in terms of benefits, cost of insurance coverage, and so on) for the existing and future policyholders in the participating lines of business. The third principle is that the actuarial structure of participating policies includes (implicitly or explicitly) a permanent contribution to entity capital, thereby assuring that there will be sufficient risk capital and new business financing for new policyholders in future years.

The entity capital of a life insurance company consists of statutory surplus plus the amount of capital which has been invested in new lines, new products, new businesses or growth of existing businesses and which is expected to be repaid in the future through charges made in the policy pricing and dividend structure. In measuring the capital charges made to policyholders under this approach, it is important to focus on the entire amount of entity capital, and not just on the amount of statutory capital.

The accumulation and use of capital in the interests of participating policyholders mandate that capital be accumulated only as necessary to assure the fulfillment of the company's insurance contracts or if it can be invested in the growth of existing businesses or in new businesses in a manner which is expected to benefit existing and future participating policyholders.

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*It is theoretically possible for a mutual company with subsidiary companies to raise equity capital by selling interests in one or more such companies. Also, in Canada, at least one mutual life insurance company has issued preferred stock. These are exceptions, however, and for most mutual companies there are many novel and complex issues that would have to be resolved before such capital-raising could be done in a large way.

Under the entity capital model, policyholders make permanent contributions to entity capital through capital charges (explicit or implicit) in the actuarial structure of the policies. These permanent contributions provide the capital required for risk assumption and business investment purposes. (There may also be temporary contributions of capital which are returned through annual and terminal dividends in the later policy years.) In determining the aggregate capital charge levels for specific participating lines of business or the charges to be made to specific classes of participating policies, account is also taken of the risk involved and the amount of entity capital used. To assure that the entity capital approach will conform to basic principles of policyholder equity and expectations, the capital charges for each policy grouping should be determined in an equitable manner, and the general form of these charges should be relatively stable over a policy's lifetime.

A relatively brief inspection will demonstrate that the entity capital approach fits quite closely the business requirements of mutual life insurance companies. In particular, it combines the overall perspective necessary to manage a large diverse enterprise in a time of rapid change while permitting the preservation of the equitable cost assessments required for participating insurance.

COMPARISON OF ENTITY CAPITAL MODEL WITH THE REVOLVING FUND MODEL

Although the Task Force believes that the entity capital approach represents the typical model of mutual company financial operations, it is not believed to be a universal model. The Task Force discussed briefly the cooperative model. Our conclusion was that cooperatives are essentially a form of organization rather than a distinct financial model. Cooperatives are organized for different purposes and involve many different forms of financial arrangements among its members. Therefore, the Task Force concluded that there was little value in seeking to compare one or more forms of possible cooperative financial arrangements with the entity capital model. This section seeks to compare the entity capital approach to another possible model of mutual company financial operations: the revolving fund model.

In the pure form of the "revolving fund model" an insurance company conducts its financial operations in such a manner that the capital resident in the company at any time has been contributed solely by the then current classes of policyholders. The company's capital is considered to be a revolving fund to which each policy in a class contributes during its lifetime and from which the amounts thus contributed (together with any net investment earnings thereon) are fully distributed to the class by the time the last policy in the class terminates. This theory has been described in a few actuarial papers and discussions as the appropriate theoretical model for mutual life insurance company financial operations.

The Task Force tested how the pricing and dividend structure would have to be modified in order to operate on a revolving fund approach. To do this, we modified the dividend scale for the 8 percent growth model company described in Appendix 1 so that a generation of new business would make no permanent contribution to surplus. As in the case of the entity capital model company, a constraint on the revolving fund model company is that statutory surplus for the company as a whole be maintained at 5 percent of reserves. The results of this study are described in the following paragraphs.

The following table shows the ultimate (stable) dividend scale for the entity capital company:

"ENTITY CAPITAL" DIVIDEND SCALE (at Conversion)
PER $1,000 FACE AMOUNT UNIT IN FORCE

Duration	Issue Age 25	Issue Age 40	Issue Age 55
1	$ 0.00	$ 0.00	$ 0.00
2	2.01	2.38	4.42
3	2.14	2.70	6.08
5	2.46	3.39	9.41
10	3.37	5.50	17.92
15	3.90	8.11	22.38
20	4.78	11.04	26.23
30	8.06	18.29	29.36
40	13.97	24.55	35.72
50	20.17	29.04	—

No terminal dividends are paid by the entity capital company.

As a first step, we assumed that the revolving fund company would pay a terminal dividend on death or surrender of $2 per unit starting in policy year 12 and grading into $25 per unit in policy year 20. The terminal dividend would be level (at $25 per unit) in policy years 20 and later. Although results are shown only for the use of the specified terminal dividend scale, we tested other reasonable scales and obtained similar results. Using this terminal dividend scale, we solved for the annual dividend scale that would maintain the desired surplus ratio for the company as a whole and that would eventually return all surplus contributions and the net investment earnings thereon to the members of the policy class. To find a unique solution, we required the revised annual dividend scale to be an initial percentage of the entity capital dividend scale in policy years 1 through 10, an ultimate percentage of the entity capital dividend scale in policy years 20 and later, and for policy years 11 through 19, percentages of the entity capital dividend scale grading linearly from the initial to the ultimate level. The solution is

- 46 percent of the entity capital dividend scale in policy years 1 through 10,
- 209 percent of the entity capital dividend scale in policy years 20 and later, and
- a percentage grading linearly from 46 percent to 209 percent of the entity capital dividend scale over policy years 10 through 20.

The following table shows the ratios of the asset share surpluses to reserves after all taxes and dividends are paid for various issue ages and policy durations. This table is similar to the corresponding 115 percent of standard table in Appendix 1. The Entity Capital Column is based on the ultimate (115 percent) dividend scale and assumes the expense and interest experience of an 8 percent growth company. The Revolving Fund Column is based on the same experience and interest assumptions as the Entity Capital Column, but reflects the adjusted dividend scale and the introduction of terminal dividends.

This analysis demonstrates it is theoretically possible to operate a company on the revolving fund financial model if the competitive markets will permit

RATIO OF ASSET SHARE SURPLUS TO RESERVES
(AFTER ALL TAXES AND DIVIDENDS)

Issue Age	At End of Calendar Year *N* (Policy Duration $N - \frac{1}{2}$)	Entity Capital Company	Revolving Fund Company
25	5	−23.9%	−12.3%
	10	− 9.2	+ 5.1
	15	− 0.2	+11.5
	20	+ 8.2	+11.6
	25	+17.2	+11.8
	30	+27.6	+13.0
40	5	−15.8%	− 7.9%
	10	− 5.4	+ 5.9
	15	+ 2.4	+11.9
	20	+ 9.8	+10.1
	25	+18.9	+ 6.9
	30	+32.2	+ 4.1
55	5	−11.4%	− 0.4%
	10	− 6.6	+13.2
	15	− 2.3	+17.0
	20	− 2.9	+10.6
	25	+12.4	+ 4.4
	30	+33.9	+ 0.7

the company to pay early year dividends that are low enough or to charge premiums that are high enough. The first question concerning the revolving fund approach is its practicality in a competitive marketplace. The Task Force believes that in competition with a product paying the entity capital dividend scale, a product paying the revolving fund dividend scale, with its sharply reduced dividends in the first 10 years, would be difficult to sell.

A second concern is the question of equity. As compared with an entity capital approach, a revolving fund approach appears to require a very much steepened dividend scale and the use of terminal dividends. In the specific application of the revolving fund philosophy presented in the test example above, there would be an increased cost of insurance under the revolving fund approach (as compared with the entity capital approach) for policies which terminate through death or surrender in the first 20 or so policy years; there would be a reduced cost of insurance for policyholders who persist beyond this period. In this example, specifically, only 30 percent of the policies issued at age 25, 28 percent of the policies issued at age 40, and 18 percent of the policies issued at age 55 would have lower costs on a 5 percent interest adjusted basis.

The Task Force recognizes that it is mathematically possible to design a revolving fund dividend structure under which the dividends to policyholders (regardless of when they terminated) would be equivalent in value to those provided under an entity capital approach, and we have made attempts to design such a structure. Although not exhaustive, these attempts confirmed our view that an equivalent revolving fund scale would rely, to an unprecedented degree, on termination dividends, would require an annual dividend scale with reduced dividends in the early years and a very different pattern throughout, or would require a combination of termination and reduced annual dividends throughout. These changes would be accentuated at higher growth rate levels. Although equity, like beauty, is in the eyes of the beholder, the Task Force has found no evidence to support the view that the revolving fund method provides a greater degree of equity than the entity capital method and some evidence to support the view that it might provide less equity.

A third concern is that it is difficult in a revolving fund approach to handle appropriately costs whose final measure cannot be established until many years after the period in which they were incurred. A prime example is federal income taxes whose ultimate level for any year will depend on subsequent audit and, perhaps, litigation.

Finally, it is difficult to apply the revolving fund theory broadly across lines of business, across classes within a line of business, or in the event of significant changes in the economic or business environment. In the revolving fund approach the focus of a company's management must be on the return to each class of policyholders of the capital contributions made by that class. This is a narrow and, essentially, short-term focus. There are clearly circumstances, for example, in which the constraint of the revolving fund discipline would require a company to forego capital investments which would significantly reduce future operating costs or increase future investment income.

As compared with the entity capital model, the Task Force believes that the pure revolving fund model could be used effectively in certain limited circumstances but that this approach could not be used as a general overall theory for mutual company financial operations.

IMPLICATIONS OF THE ENTITY CAPITAL MODEL ON POSSIBLE DEMUTUALIZATION PROCESSES AND STRUCTURES

Our discussions of the entity capital model have led us to the following conclusions with respect to the conversion process:

1. In the normal financial operations of a mutual life insurance company, policyholders of participating contracts would expect to receive policy dividends and guaranteed benefits. Maturity or surrender of the contract would ordinarily bring no other expected compensation for the simultaneous termination of membership rights. Termination dividends are considered as policy dividends in this analysis. Therefore, any valuable consideration given to members in a conversion action as compensation for cancellation of their membership rights has no counterpart in the ongoing financial operations of a mutual company and there is no recognized basis in precedent, experience or membership expectations for the determination of such valuable consideration.
2. Although the foregoing description of the entity capital approach states that the mutual company makes (explicit or implicit) capital charges through the actuarial structure of the policy, the observations of the Task Force members with respect to the practices of their companies is that at least some portion of these charges is an indistinguishable part of the actuarial pricing structure. Therefore, if the consideration given to policyholders for surrender of their membership is to be based (in whole or in part) on the actual capital charges made by the company, the figures will have to be derived from analyses comparing actual historical and projected cost and income levels with the applicable premium and dividend structure. This subject is discussed in greater length in Section VI of this report.
3. Regardless of the specific methodology selected to estimate the accumulated capital contributions for policyholders of different classes, the total capital of the company

at the time of conversion will usually be found to have been contributed in part by existing policyholders and in part by policyholders whose policies are no longer in force.

4. Using the entity capital approach, it is possible to assign a specific meaning to the concept of "the participating policyholders reasonable dividend expectations." The definition is that the reasonable dividend expectations of participating policyholders is a continuation of the current dividend scale if current experience continues and, if experience changes, equitable modifications of that scale.

APPENDIX 3

POLICIES INCLUDED IN CLOSED BRANCH

This appendix addresses the question of which policies or policy classes should be in a closed branch or branches. The report of the Task Force suggests three criteria for inclusion of business in a closed branch: substantial dividends, broad averaging of experience, and a diminishing number of policies over time. These criteria suggest the following general guidelines for inclusion or noninclusion of particular classes of policies in the closed branch:

Include:

- Participating individual life insurance policies, annuities and supplementary contracts in force on the conversion date.

Do Not Include:

- Participating individual life insurance policies, annuities or supplementary contracts that terminated before the conversion date.
- Nonparticipating policies or contracts, unless closely linked with participating policies that are in the closed branch.
- Participating group pension separate account business where participation consists of direct pass-through of investment experience under terms described in the contracts.
- Pension guaranteed interest contracts (even where written as participating) which provide guarantees of principal and interest with no expectation of dividends or other nonguaranteed elements.
- Participating group pension contracts and participating group life and health insurance policies which are individually experience rated and/or which involve, essentially, a direct pass through of experience (via a dividend formula or an annual investment year method allocations of investment income) and for which the experience rating process is sufficiently well understood by policyholders to provide assurance that their dividend expectations will be maintained after conversion.

Whether or not to include other participating group pension contracts, other participating group life and health insurance, and participating individual health insurance will depend upon the relative significance of policyholders' expectations regarding policy dividends and other elements of participation.

APPENDIX 4

ESTABLISHMENT AND MAINTENANCE OF A CLOSED BRANCH

A mechanism for helping assure the maintenance of reasonable policyholder dividend expectations is to establish a closed branch for certain existing participating policies and to allocate to this closed branch sufficient assets to assure the payment of the current dividend scale (in addition to the contractual guarantees) if current experience continues. The assets would be committed to the closed branch; none of these assets would ever revert to the benefit of shareholders. This appendix presents the issues which the Task Force has identified and investigated with respect to the establishment and maintenance of such a closed branch.

The closed branch would not be a separate account in the legal sense. It might be a segment of the general account; at a minimum it is a clear identification that specific assets (or portions of such assets) have been assigned to the closed branch.

The assets assigned to the closed branch may be the entire amount of each asset, or they may be shares of assets owned by the general account. If the closed branch is large enough to permit reasonable diversification, the management of assets in the closed branch would be facilitated if the closed branch "owns" the entire amount of the assigned assets. *Notwithstanding the establishment of the closed branch, all the general account assets of the company stand behind the obligation of the company to pay the contractual benefits guaranteed by the policies in the branch. The principal effect of decisions made with respect to operation of the closed branch is on the amount and incidence of dividends paid on those policies included in the branch.*

The balance of this appendix is divided into six sections to deal with specific issues:

1. the overall amount of and the specific assets which should be placed in the closed branch initially,
2. the relationship of the initial selection of closed branch assets to the amount of future dividends,
3. the expense and other charges to be made to the closed branch after conversion as part of its ongoing operations,

4. the actuarial opinions with regard to equity and adequacy of closed branch assets at conversion,
5. the actuarial opinions with regard to equity and adequacy of ongoing closed branch financial operations,
6. historical precedents for closed branch operations.

1. ASSETS SET ASIDE TO FUND THE CLOSED BRANCH

The objective is to maintain reasonable dividend expectations by setting aside sufficient assets to provide cash flows (from anticipated investment income, maturities, sales or exchanges) which, with future premiums and a continuation of current conditions, are adequate to fund

- all policy benefits and dividends, the latter payable under the then current scale,
- any expenses and taxes that will be charged against the closed branch (see Section 3).

Definitions

All policy benefits: Appendix 3 discusses which broad types of policies should be placed in the closed branch. Decisions must also be made as to whether this term includes all benefits provided by these policies and successor policies. In the case of individual life insurance, for example, would the following be included in the closed branch?

- nonparticipating riders attached to par policies,
- policies that may be issued in the future under the provisions of "closed branch" policies (e.g., under guaranteed insurability options),
- supplementary contracts arising from terminations of policies in the closed branch, and
- insurance nonforfeiture options (extended term insurance may be nonparticipating) which may be reinstated to premium paying.

The Task Force believes that operation of the closed branch would be most effective if all elements of any policy belonging to the branch are treated as part of the branch. Riders, as well as policies issued in the future under options in current policies, would seem to meet this test. Supplementary contracts might or might not meet the test, depending on whether they are participating or nonparticipating and on the way the company has viewed and managed them financially. Policies on nonforfeiture options that might be reinstated probably should be included in the closed branch.

Current conditions: The Task Force believes that this term means the mortality, investment income, expense, taxes, lapse, and so on, experience consistent with the experience factors underlying the dividend scale that is applicable to closed branch policies when the closed branch is established. The experience assumptions used in determining the amount of assets required initially in the closed branch should reflect current conditions. With regard to the rates of interest assumed for the investments of future net cash flows, this definition of current conditions would require that the assumptions recognize the way in which investment income experience factors are being determined (portfolio vs. investment year) for the several classes of business involved and the current measures of the experience factors for the respective classes. Similarly, expense rate assumptions might include provision for future inflation consistent with the expense treatment implicit in the current dividend scale.

Maintain reasonable dividend expectations: Although this term is subject to many possible definitions, the Task Force believes that the definition of reasonable dividend expectations which conforms to the entity capital approach is that the present dividend scale will be continued if current experience continues and that, if experience changes, dividends will be adjusted to reflect, equitably, the effects of these changes.

A necessary condition for meeting this definition is that the assets selected initially for the closed branch be in an amount and character to permit the payment of the then current dividend scale (at the time of conversion) if the experience levels on which that scale is based (that is, current experience) continue. To meet the definition fully, it is also necessary to reflect, appropriately and equitably, changes in experience through dividend scale revisions in the ongoing management of the closed branch. The following are suggested criteria for postconversion dividend scale revisions for closed branch policies:

- The revised dividend scale is set such that the cash flows from premiums and assets (including reinvestments) approximate, under then current conditions, the sum of the policy benefits, chargeable expenses, and dividends (under the revised scale),
- The contribution principle is followed as the basis for revising the dividend scale, and
- As a corollary, the durational effect of the revision to the dividend scale is not distorted so as to create potentially a "tontine effect" for long-term policyholders or to reduce materially potential future dividends for these policyholders.

Primary Considerations in the Initial Selection of Investments for a Closed Branch

In general, the basic pool of assets from which to select assets to be placed in the closed branch are those assets that, at the time of conversion, are allocated to or are in general account segments established for the lines of business to be included in the closed branch, together with any additional assets held by the company in a separate corporate account or surplus segment.

To provide maximum continuity of dividend treatment, particularly in a "portfolio rate" company, the assets selected for the closed branch should have a pattern of future cash flows that matches as closely as possible the pattern of cash flows that would have occurred if the company had not demutualized and had continued to write participating business. This can only be approximated in the operation of the closed branch. In the early years, the closed branch will have insurance cash flows (premiums, less benefits, expenses and dividends) that are more positive than if the branch had remained open because the closed branch will not include new business. After a few years the reverse will be true.

In selecting assets, the converting company must recognize the need to balance the two objectives of stability of dividend scale and responsiveness to possible improved experience.

To the extent permitted by the constraints described below, assets could be selected initially for the closed branch in such a manner as to match the insurance cash flow requirements and therefore minimize the effects of future reinvestment on the closed branch, at least after the early years. The combination of insurance cash flow and investment income in the early years will ordinarily be positive in any case. This approach would have a stabilizing effect on dividends; the dividends will not increase in response to improved investment experience as much as they would have otherwise, but neither will the dividends decrease in response to deteriorating investment experience as much as they would have otherwise.

An approach involving shorter initial asset maturities and earlier reinvestment of assets in the closed fund might simulate more closely the open fund (or new money) effects that participating policyholders in a portfolio rate company could have expected in the absence of the conversion action. Such an approach would, however, expose closed branch policyholders to more reinvestment risk.

One possible approach is to stress responsiveness in the early years (when the fund has positive cash flow and most of the original policyholders are still present) and shift gradually to stress stability in the later years, when insurance cash flow is negative and the policyholder group is shrinking rapidly.

Other Considerations Relating to the Selection of Investments for the Closed Branch

The closed branch should contain the policy loan asset for policies in the branch. The cash flow test set forth at the beginning of this section of the appendix must take into account cash flows, positive and negative, expected to result from the ongoing effects of policy loans and their repayment within the closed branch. Similarly, assumed cash flows associated with dividends should — especially in the case of direct recognition dividend formulas — take account of the effects of expected policy loans on dividend payments.

Should the company's current practice regarding allocation of investment income among lines of business be a factor in deciding which specific assets to select for the closed branch? Is the answer different depending on whether the company uses a segmentation method (which would permit the selection of whole assets from the segment) or an investment generation method or other method (which usually would not permit the assignment of whole assets to the closed branch)? Considerations include the following:

- the proportion which the business being placed in the closed branch represents the business of the entire company. In a company that consists principally of participating individual life business, the choice will be limited.
- effects on other lines of business. If the company has lines of business involving essentially a pass-through of investment performance to individually experience rated policyholders (for instance, group pension immediate participation guarantee business), it may not be possible to take a portion of their assets to establish the closed branch.
- the relationship between this issue and the issues discussed in Primary Considerations above. The individual life line may currently have assets (or shares of assets) that are appropriate for an open branch but not for a closed branch.

Projected asset cash flows must, in general, take into account the possibility of asset default as to principal or interest:

- If the risk of default is to be borne directly by the closed branch, provision for possible default losses should be reflected in the projected asset cash flows.
- If the risk of default is to be borne by the newly created stock company, it would be reasonable for the closed branch to pay a charge for this protection to the stock company; such a charge would be treated as an expense of the closed branch and would be provided for as such in the original projection of closed branch cash flows.

- A possible approach to the establishment of a small closed branch would be to provide the closed branch with assets of high quality and low risk of default, to reduce the degree of expected fluctuation in future asset cash flows.

As the objectives of the closed branch are to provide the greatest possible assurance of stability and continuity of postconversion dividend treatment and to insulate the dividend treatment of closed branch policyholders from the ongoing financial operations of the rest of the stock company, the Task Force believes that it would be inappropriate for investments other than bonds, mortgages and similar fixed yield investments to be allocated to the closed branch. Of particular concern are the following:

- Company occupied real estate: The yield on these assets is not always established on a market basis and the allocation bases may be arbitrary. Nevertheless, there may be circumstances in which it may be satisfactory to include company occupied real estate in a closed branch. A situation in which the rental charges to closed branch from company owned real estate closely approximate the amount of investment income credited (when the branch is established and for the then foreseeable future) represents such a circumstance. The key question is whether the inclusion of company owned real estate creates a material risk of dividend uncertainty and fluctuation for closed branch policyholders.
- Subsidiary companies: It is unlikely that investments in subsidiary companies would meet the closed branch objectives because the cash flow from such investments and the operations of the subsidiary companies would be under the management of the stock company.
- Common stocks of unaffiliated companies and real estate equity investments that do not raise the questions discussed above, but their full returns and cash flows will not be realized until their ultimate sale: Inclusion of these assets in the closed branch may complicate both the initial assessment of the amount of assets required and the ongoing dividend determination for the branch.

The total amount of assets selected for the closed branch could vary significantly, depending on whether the assets selected are low coupon bonds (issued long ago) or are high coupon bonds (issued more recently), and still satisfy the "cash flow" criterion set forth at the beginning of this section.

If the applicable state law or the converting insurer's conversion plan contemplates the determination of the aggregate amount of compensation to members and/or the allocation of that amount among members based on their contributions to equity and the measure of contribution employed for this purpose uses the accumulated assets minus closed branch assets methodology described in Section VI of the report, it is important to recognize that these values could be distorted if the average yield on the assets in the closed branch differs materially from the average current experience rates underlying the current dividend scale. Accordingly, it is important that in this case the average yield on the assets in the closed branch meets this additional criterion.

Provision for Adverse Lapse Risk

The purpose of establishing a closed branch is, in a broad sense, to permit continuation of the company's preconversion dividend practices after the conversion. The initial allocation of assets for the closed branch is determined as the amount necessary (with future premiums) to pay guaranteed benefits and current scale dividends on the assumption that current experience levels will continue. As experience changes, over time, dividends would be revised accordingly and the original intent would be served. A problem may arise, however, if there is a change in experience which results almost solely from the conversion, itself, and the coincident establishment of the closed branch. The Task Force believes that there is one experience element for which the conversion process might cause a material change in the experience levels — lapses and surrenders. The effect of this problem is illustrated below:

Consider the illustrative financial operations presented in Appendix 1. The closed branch of the 8 percent growth company would have at the time of its establishment

$1,830 million of assets	(because the economic environment is constant throughout the study period, this figure represents both a book value and a market value)
$2,194 million of current obligations (as of the policy anniversaries)	(cash values plus the dividend liability; this is in the nature of a book value).

Clearly, in the extreme example of an immediate termination of all policies in the closed branch, there would be an asset shortfall (which would have to be made up from the rest of the assets of the company). A still extreme but more probable example would be additional surrenders in the first year after conversion equal to 10 percent of the initial in-force business. In this example, this level of excess surrenders would require either an increase of $37 million (from $1,830 million to $1,867 million) in the initial amount of assets included in the closed branch or a reduction of approximately 4 percent in all dividends payable after the first year of operation of the closed branch.

In the work leading to the determination of the amount of assets assigned to the closed branch, the company should test the effects of different levels of higher voluntary termination rates. The company may find it prudent to set aside some additional assets, as appropriate, to reduce the impact on policyholder dividends. (If the higher voluntary termination rates do not materialize, larger dividends will be paid to policyholders in the closed branch.) In addition to adding modestly to the total amount of assets in the closed branch, the company may wish, as well, to shorten the maturities of the closed branch assets.

Ongoing Asset Management

Having identified the specific assets to be placed in the closed branch initially, which may be whole assets and/or specified shares of identified general account assets, several issues regarding the ongoing asset management of the closed branch must considered:

- In the investment of the closed branch cash flow, is it appropriate for the closed branch to participate in shares of specific investments with other general account segments? The Task Force believes the answer will often be yes, especially in view of the decreasing size of the closed branch after it is established.
- Because the closed branch will have short-term liquidity needs, is it appropriate for the closed branch to participate in a short-term asset pool managed on a company-wide basis? The Task Force believes that such participation could be cost-efficient.
- If, in any year, the closed branch generates negative cash flow, the branch, in effect, will have "borrowed" from other segments of the general account to cover such deficiencies. To avoid this, the closed branch could sell (on the open market) assets wholly owned, or it could sell (to other segments of the general account) the fractions of assets jointly owned with these other segments. If the closed branch is to "borrow," procedures for setting interest rates and repayment schedules must be established. Companies have addressed this problem (implicitly or explicitly) in their Investment Year methods or Investment Segmentation plans. One common approach is to adopt the weighted average maturity structure and interest rate for all investments made in the period as the term of any interline loan made during the period. Other approaches may use explicit negotiations to set the loan term and interest rate of a interline loan.
- It may be appropriate to "swap" investments among the closed branch and other general account segments after the closed branch is established if this reduces transaction costs and benefits both accounts. However, care must be taken to demonstrate

that the closed branch is neither advantaged nor disadvantaged. If the stock company has assumed the default risk for the closed branch, it may be necessary for the converted company to buy, or swap for, closed branch assets that go into default.

2. ADJUSTMENTS IN DIVIDEND FORMULAS AFTER CONVERSION; RELATIONSHIP TO THE TYPE AND AMOUNT OF ASSETS SELECTED INITIALLY

Because the statutory value of the assets in the closed branch will not be equal to the amount of the corresponding statutory liabilities (in most cases the assets will be smaller), the dividend formula cannot be geared to pay out all statutory gains automatically. The goals for ongoing dividend formula decisions are

- to assure, as nearly as possible, that the fund's assets are exhausted when its liabilities are discharged and
- to maintain equity among members of the closed branch, particularly between those who terminate relatively early and those who terminate relatively late.

The basic test for the first goal is whether the then current dividend formula (or a proposed revision) can be maintained given the then current experience and assets. To help meet the second goal, the actuary may wish to use a gain and loss analysis not unlike that used by pension actuaries. Because these two goals are now paramount, the annual dividend setting process is not identical to the process before conversion. The following two points suggest some of the new aspects of the process after conversion.

The monitoring of experience factors serves two functions:

- It provides a basis for updated cash flow analyses and thus a determination of whether the dividend scale should be maintained, enhanced, or reduced.
- After the above determination is made, it provides information concerning the types of dividend formula changes that should be considered.

In general, mutual company policyholders are accustomed to a series of small changes in dividend scales (as opposed to abrupt changes). In addition, when companies have found it necessary to decrease dividend scales, they frequently provided that the absolute amount of a policyholder's dividend in the year following such a scale decrease will not be less than in the prior year. These customs have implications for the types of dividend scale changes that should be considered in the management of a closed branch, especially in its early years. On the one hand, it is important to reflect changing experience as it occurs (because failure to do so may create exaggerated effects, either positive or negative, to the policyholders who persist over the long term). On the other hand, the interpretation of experience trends is difficult until a reasonable period of time has passed and, as noted, policyholder expectations may not be met by abrupt dividend scale changes. Among the devices that might be considered are

- the use of a terminal dividend scale (whether or not one was in effect prior to the creation of the closed branch) with the understanding that adjustments in that scale, either upward or downward, might be more frequent and/or more substantial than adjustments in the scale of annual dividends. In this manner, the terminal dividend scale could take up some of the slack caused by an actuary's understandable reluctance to immediately reflect all perceived experience factor changes in the annual dividend scale.
- if early experience is favorable, scale changes that tend to increase the *slope* of the dividend scale more than its current level, so that any future needed scale reductions would be unlikely to lower the absolute level of dividends (in comparison to the dividends paid in the prior year at an earlier duration).

3. WHAT EXPENSE AND OTHER CHARGES SHOULD BE MADE TO THE CLOSED BRANCH AS PART OF ITS ONGOING FINANCIAL OPERATIONS?

The fundamental principle for a participating policy is that it participate in the experience of the class of policies to which it belongs. Each company has an established framework which is used to determine the charges and credits to be made to each class. To the extent feasible, this framework should continue to be applied in selecting the experience charges to be made against the closed branch. In this way the relationship that the policyholders had with the company before conversion could be continued.

Several other important criteria are

- control. It will be necessary to audit the performance of this account, and thus, the rules for determining expenses and other charges to the closed branch and the accounting therefore must be subject to clear definition and determination.
- practicality. It would be unfortunate if these rules required such an elaborate administrative mechanism that the cost to the company and its policyholders is out of proportion to their value.
- effect on public perception. A decision to omit certain charges from the operation of the account will cause the starting balance to be smaller. This smaller amount needed in the account will mean that corresponding additional funds will have to be held outside the account as liabilities on the company's balance sheet in order to provide for the charges that will not be levied against the closed branch. Conversely, if charges against the closed branch are perceived by the public as ones not properly chargeable to the account, there may be resistance to the terms of the conversion plan.

Given the criteria above, consider several categories of charges:

- Expense Charges: There may be a considerable debate about the amount of maintenance expenses to be charged against the closed branch. The major issue concerns the portion of the expenses of the marketing organization which are allocated as renewal or maintenance expense, rather than as acquisition expense. It is desirable to continue to treat these expenses as renewal or maintenance expenses, if practical, because the dividend scale includes a charge for such expenses.

  Although it is possible, by reducing the amount of assets allocated initially, to operate the closed branch without charging to it some or all of these maintenance expenses, this approach would considerably complicate the process. It would, for example, require the establishment of a liability for such charges outside the closed branch in order to avoid future drains on the company's capital from these expenses. In addition, it would leverage the impact on dividends of higher (or lower) than anticipated termination rates and variations in experience from those used in establishing the closed branch initially.

  Of the various alternative treatments of maintenance expenses that might be adopted, the approach most consistent with the model of continued participation for the closed branch would be to make maintenance charges to the closed branch in a manner consistent with past practices and reflecting actual cost levels.

- Federal Income Tax Charges: There are two reasonable approaches to this charge. The first is to continue the preconversion treatment and to charge the closed branch with the share of the tax allocable to policies in the closed branch based on the company's then current tax allocation methods. In this case, the initial asset amount would be established anticipating the continuation of the tax allocation techniques in use by the company and of the present tax laws. If tax laws change, the closed branch should share in the resulting tax increase or tax decrease as it does in other experience.

  The advantage of making tax charges is the continuing participation by participating policies in tax law: benefitting policyholders if taxes are reduced and charging them appropriately if taxes are increased.

  Under the second approach the tax charge to the closed branch would be limited to the tax charges which the company would incur from the financial operations of the closed branch. Although, on a pretax basis, the closed branch will involve no net income to the company, there will usually be an excess (when the closed branch is established) of closed branch liabilities (on which tax has been deferred) over closed branch assets (on which tax has been paid). The run-off of this excess will produce taxable income to the company. The aggregate amount of such taxable income will be the tax accounting measure of the closed branch liabilities less the sum of the closed branch assets before any provision for taxes and the additional assets required to provide for the tax charge, both of the latter being measured on a tax accounting basis. Under this approach the closed branch will not participate in future changes in tax laws.

There are two other aspects of this choice which are important. The first is to recognize that, if policyholder contributions are being determined as the excess of accumulated assets over closed branch assets and closed branch assets are determined under the second (no direct tax charge) charge approach, membership values will be overstated. This is because of the discontinuity in the handling of taxes between the two terms of the contribution calculation. Therefore, a special adjustment in this calculation will be required to eliminate this overstatement. On the other hand, the use of the first method would, in the absence of a special adjustment, overstate the deferred tax liabilities on the converted company's GAAP balance sheet. This is because the liabilities for the closed branch will include provision for taxes to be paid in future years and these liabilities will be included (in whole or in part) in the company's deferred tax liability. If this method is used, some adjustment for this duplication would have to be reflected on the company's GAAP balance sheet.

Another issue under the subject of taxes has to do with the "add-on tax," which would not be applicable after conversion. A fair share of the "add-on tax" likely will have been incorporated in the costs assessed against current contracts in determining present dividend scales. The essential question is whether the change in applicability of this tax is to be treated as an experience change (and thus reflected in the initial postconversion dividend scale) or whether this change is the result of a corporate change (with any tax savings serving to increase the value of the company and, presumably, the aggregate amount of policyholder compensation). There is no philosophically correct approach to this question and it is not clear to the Task Force that either method is superior to the other in all cases. Although the Task Force believes that the use of this charge to enhance the value of the company will be superior in most cases, this judgment should be made taking into account the facts and circumstances of the case.

- Reinsurance: The effect of existing reinsurance contracts should continue to be reflected in the closed branch if the financial effect of reinsurance has been reflected in the dividend scale.

4. ACTUARIAL OPINIONS WITH REGARD TO EQUITY AND ADEQUACY OF CLOSED BRANCH ASSETS AT CONVERSION

The demutualization bill now under consideration by the New York State Legislature requires an actuarial opinion at the time of conversion by a qualified actuary as to

> the reasonableness and sufficiency of the asset allocation ... in an amount which together with anticipated revenue from such business is reasonably expected to be

> sufficient to support such business including, but not limited to, provision for payment of claims, expenses and taxes, and to provide for continuation of current payable dividend scales, if the experience underlying such scales continues and for adjustments in such scales if the experience changes.

The primary audience for this initial actuarial opinion is state regulators and the existing participating policyholders. It should be communicated in appropriate form (subject to safeguards such as in the proposed New York law to permit companies to shield proprietary information) to policyholders as part of the plan of reorganization.

Stockholders and the public are secondary audiences. If the assets in the closed branch are inadequate, the company may have to reduce dividends significantly or may have to make good the policy guarantees, with the resulting unfavorable publicity and impact on stockholder values.

The initial actuarial opinion would be based essentially on a gross premium valuation; plus a cash flow analysis. The net insurance cash flow would be the year-by-year projections of

- future claims, cash surrenders, net cost of reinsurance, expenses and taxes, plus
- future dividends on current scale, less
- future premiums.

These projected insurance cash flows would be compared with the investment cash flows from the assets assigned to the closed branch originally and from assets purchased subsequently for that branch.

Assumptions as to future levels of mortality, interest and expense ought to be based on the experience levels underlying the dividend scale at the time of conversion, except that the adequacy of the asset-liability cash flow coverage should be tested under reasonable variations in experience assumptions. Although margins for future adverse deviations are available through the dividend mechanism and, accordingly, there should be no need to introduce significant additional margins in the assumptions beyond current experience levels, it is important that possible effects of adverse deviations be tested to assure that the dividend mechanism can absorb such variations in experience. Consideration might be given to introducing small additional margins (for instance, 1 percent or 2 percent of assets) to help maintain current dividend levels through moderately adverse fluctuations in experience, particularly increased voluntary termination experience. If the membership value determinations involve closed branch measures, care must be taken to assure that there is an equitable relationship for each of the policy classes between the reductions in membership value (resulting from asset margins) and the possible risks for which margins have been established.

5. ACTUARIAL OPINIONS WITH REGARD TO EQUITY AND ADEQUACY OF ONGOING CLOSED BRANCH FINANCIAL OPERATIONS

Actuarial opinions with regard to the equity and adequacy of ongoing closed branch financial operations, if required, should focus on the relationship of closed branch assets to the then current dividend scales and on the need, if any, to revise those dividend scales. The analyses leading to an actuarial opinion should be performed every three years or, perhaps, even more frequently if experience is changing rapidly. Management would also be a primary audience for such opinions, but on a review basis, not on an approval basis as is the case with dividend scales currently.

The closed branch assets should be maintained as a fund with premiums and investment and other income credited from the assets and business assigned to it, but with claims, surrender benefits, net cost of reinsurance, expenses, taxes, and dividends charged as incurred. Certifications, if any, for this aspect of operation of the closed branch should be an accounting, rather than an actuarial, responsibility. In the analysis of closed branch experience, the actuary can evaluate changes in investment income, mortality, expense, and lapse experience and recommend changes in the dividend scale. In these analyses, the actuary cannot rely solely on statutory earnings as a guide to the appropriateness of the total payout of dividends. On a statutory basis — assuming the closed branch assets are less than the statutory reserves held for the business — there will be an initial deficit position which must be worked off by positive statutory earnings after dividends in the future. Here, as for the initial actuarial opinion, the ongoing adequacy of the closed branch assets should be based primarily on a gross premium valuation and a cash flow analysis.

6. HISTORICAL PRECEDENTS FOR CLOSED BRANCH OPERATIONS

The principal sources of historical precedents for closed branches of business are assumption reinsurance of business from insolvent companies. However, the best examples of such branches are probably the life insurance programs established for military veterans. The United States Government Life Insurance Program began January 1, 1919, to handle the insurance converted from the War Risk Term Insurance of World War I. Approximately 1,150,000 policies were issued before the program was closed to new issues in 1951; of these, 62,475 policies were still in force at the end of 1985. Comparable blocks of business exist for World War II and Korean

War Veterans. These closed branches have been operated to be self-supporting and to avoid tontine situations. However, they are not completely comparable to the closed branch suggested in the Task Force report because no administrative or sales expenses are charged to the veterans' business and because the blocks of business are probably more homogeneous with respect to product types, attained ages, and issue dates. On the other hand, they are comparable in that: an industry advisory group has had the role of "independent consulting actuary," as suggested by the Task Force report, and an occasional use of gross premium valuations combined with the regular monitoring of the pattern of emerging gains has kept the surplus at appropriate levels.

APPENDIX 5

POLICYHOLDERS' CONTRIBUTIONS — POLICIES INCLUDED IN CLOSED BRANCH

Discussed here are the issues involved in the determination of policyholders' contributions, that is, the actuarial component of membership values, for policies included in the closed branch. The treatment concentrates on the second approach described in Section VI of the report, the method in which the policyholders' contribution for a class of policies is defined as the excess of the assets accumulated with respect to the in-force policies in that class over the assets that, together with future premiums, are required to meet the policy guarantees and policyholder dividend expectations (if current experience continues). For policies in the closed branch, the latter item would be the assets initially included in the closed branch with respect to such policies. The focus of this appendix is the former item, the assets accumulated with respect to a class of in-force policies.

The Task Force explored three major categories of issues: the classes of business with membership rights that should be included in the calculation of policyholders' contributions (Section 1); the methods that should be used to calculate assets accumulated with respect to a class of in-force policies (Section 2); and the historical experience assumptions that should be used in the calculation of these asset accumulations (Section 3).

1. THE CLASSES OF BUSINESS WITH MEMBERSHIP RIGHTS

By law or by company charter, the vast majority of the converting company's policyholders will have membership rights and be eligible to receive value for the cancellation of membership rights upon conversion to a stock company. Some with membership rights usually will not be placed in a closed branch (for instance, large group policyholders), and some without membership rights may be placed in a closed branch (for instance, those with policies issued after the conversion is announced but before the conversion is completed). Some classes within the individual lines (which will commonly be placed in a closed branch) that may offer the company some choice as to whether compensation for membership rights should be offered in the conversion plan are the following:

1. policyholders terminated by death, lapse or surrender in recent years,
2. policyholders with nonparticipating contracts such as immediate annuities,
3. policyholders on nonforfeiture options,
4. supplementary contractholders,
5. policies arising from conversions of group insurance coverage,
6. reinstated policies in force at the time of conversion,
7. reinstated policies whose reinstatement was effected after the conversion plan was announced,
8. policyholders in subsidiaries,
9. policyholders obtained through assumption reinsurance arrangements,
10. individual health policyholders with various renewal provisions, and
11. individuals on lifetime disability (monthly indemnity) claims whose underlying policy has already terminated on account of age.

The applicable conversion law may help in the resolution of these issues. Otherwise, if the distinction between participating and nonparticipating business is clear in practice and if voting rights follow that distinction, then the company may decide the issue of classes 2, 3, 4, 5, 6, 9, 10, and 11 using that distinction. With respect to class 1, setting a cutoff point for terminations may depend, in part, on the availability of information on past terminations in the company's records. It seems reasonable to exclude class 7 in order to exclude reinstatements made to profit from the conversion and to avoid diluting the interests of policyholders otherwise eligible. Recent terminations may be eligible anyway, under class 1. The treatment of class 8 (those in subsidiaries which likely have been issued on a nonparticipating basis) may depend on past statements made by the company.

2. THE METHODS THAT SHOULD BE USED TO CALCULATE ASSETS ACCUMULATED WITH RESPECT TO A CLASS OF IN-FORCE POLICIES

Once the classes of eligible policyholders are established, the actuary will build a model of in-force policies. A number of representative age-plan cells should be selected for representative years of issue to constitute the model. In addition, the actuary should consider whether, for particular age-plan cells, further subdivisions are required because the assets accumulated for these cells could vary materially depending on characteristics such as the following:

1. Plans with high policy loan utilization versus plans with low policy loan utilization;
2. tax qualified versus nontax qualified;
3. career agent versus broker produced business;
4. simplified underwriting versus regular underwriting;
5. reserve basis; and
6. mortality basis (American Experience, 1941 CSO, 1958 CSO, 1980 CSO) when issued in the same year.

When defining model cells, the actuary has to decide when to expand and when to contract the current dividend scale experience classes.

As a general principle, the Task Force strongly believes that the determination of membership values upon conversion should not be an occasion to undo or to otherwise alter past dividend actions of the company.

Given this principle, to what extent should the actuary be permitted to create new experience classes in comparison to the company's past underwriting and dividend practices? That is, to what extent should the assumptions distinguish variables not used in the past to differentiate premiums or dividends? Examples might include investment year, policy size, policy loan utilization, tax basis and underwriting basis. The conclusion of the Task Force is that the actuary should use the dividend classes in effect in a past year when calculating the contribution to current assets made in that year.

On the other hand, to what extent should the actuary be permitted to consolidate old experience classes because past premium differences and dividend practices can be assumed to have equalized asset accumulations? Examples might include sex, substandard classes, premium mode, premium paying period, benefit period, and pattern of face amount. The conclusion of the Task Force is that a practical course should be taken unless there are clear, demonstrable and material distinctions that would be lost in such a consolidation.

The actuary needs to next consider the formula to calculate assets accumulated with respect to a class of in-force policies.

The calculation of aggregate assets accumulated with respect to a class of policies, *including both in-force and terminated policies of the class,* is relatively straightforward. Such assets are simply the accumulation of income items such as premiums and investment income, less the accumulation of disbursement items such as death and surrender payments, dividends, expenses and taxes. The same methodology applied separately to the in-force policies and the terminated policies of a class would clearly be flawed because, for example, there are no deaths among the in-force policies and there would be no charges for cost of insurance. On the other hand, policies in the terminated class would have borne the full burden of death benefits paid. This illustrates the fact that the calculation of assets with respect to in-force policies of a class must involve charges or credits which take into account at least some aspects of the financial experience on terminated policies. The key question is how to charge the in-force and terminated policy groupings, respectively, for the costs of (in excess of accumulated assets) of surrender benefits and death claims.

The traditional treatment of death claims (that is, charging in-force policyholders with the cost of insurance) was accepted as appropriate by the Task Force; we believe, however, that the decision as to the extent to which surrender costs should be made against in-force policies is a judgmental one that should take into account all relevant factors, including, particularly, past pricing philosophy and practices. The Task Force makes no specific recommendation in this latter area, but, instead, seeks to illustrate the effect of different approaches.

Using data for the model company described in Appendix 1, the Task Force has illustrated in Table 5-1 the asset accumulation numbers under three different approaches to handling termination costs. These results are illustrative only and are not intended to be complete or determinative.

The starting point in the calculation is the accumulation of assets for in-force and terminated policies under a method which charges the costs of deaths and voluntary terminations only to the terminated policy grouping. As shown on Line 1 of Table 5-1, this mechanistic approach yields $2,679 million in assets for in-force policies, an amount which is greater than the total assets in the model company ($2,570.3 million). The assets accumulated by terminated policies, which are after deductions for the full amount of all death claims and surrenders, account for the difference, a negative $108.7 million.

The First Approach

In-force policies are charged with the cost of insurance, that is, their share of the cost of death claims on policies terminated by death. This adjustment

TABLE 5-1

ASSETS ACCUMULATED AT CONVERSION
IN MODEL COMPANY
($ Millions)

Approach to Calculating Assets Accumulated with Respect to Policies In Force	Accumulated Assets		
	For Policies In Force	For Terminated Policies	All Policies
1. Mechanical Method	2,679.0	(108.7)	2,570.3
2. Cost of Insurance (COI) Charge	(325.6)	325.6	0.0
3. Approach 1: with COI Charge = 1. + 2.	2,353.4	216.9	2,570.3
4. Unamortization Acquisition Expense (UAE) Charge	(0.5)	0.5	0.0
5. Approach 2: with COI and UAE Charges = 3. + 4.	2,352.9	217.4	2,570.3
6. Approach 3:			
a. Accumulated Charges for the Cost of Capital	177.1	286.0	463.1*
b. Assets Assigned to Policies in Force (other than the assets corresponding to accumulated charges for the cost of capital)	2,107.2	0.0	2,107.2
c. Total Assets	2,284.3	286.0	2,570.3

*Of this amount, $16 million is attributable to the payment of lower dividend levels in the early years of the model company's financial operations.

is shown on Line 2 of Table 5-1, where the charge also appears as a credit to the terminated policy assets. Line 3 shows that, after this $325.6 million adjustment, the assets are $2,353.4 million with respect to in-force policies and a positive $216.9 million with respect to terminated policies. Approach 1 is used in Appendix 1.

Approach 1 handles death claim charges in an unexceptional manner. With respect to voluntary terminations, however, this approach assumes that surrender values paid are fully chargeable to the asset accumulations of terminated policies and that there is not and there should not be a charge to in-force policies for any excess of the surrender values allowed over the assets accumulated. It is, at least, an arguable point that the level of surrender values (like the death benefit amounts) is a contractual benefit which is chargeable to all policyholders and that the cost of surrender values paid in excess of assets accumulated should be spread broadly. The next two approaches, described below, use the same method of handling death benefits as Approach 1 but offer different ways in which to treat voluntary terminations. Each set of adjustments should be added to the results for Approach 1, but they are mutually exclusive.

The Second Approach

Under this approach, in-force policies are also charged with the losses from unamortized acquisition expenses upon lapse. The policy sold by the model company produces a small cash strain in the first year after issue because of the acquisition expenses. Under Approach 2, this strain is amortized over six years as a level percent of in-force premium. This means that when a policy terminates during this period, the unamortized acquisition expense is borne by the remaining policies. The accumulated effect of this on the policies in force at the time of conversion is $0.5 million which is shown on Line 4 of Table 5-1. This approach may be added to Approach 1. Therefore, after making this charge to in-force policies, and the offsetting credit to terminated policies, assets accumulated are $2,352.9 million with respect to in-force policies and $217.4 million with respect to terminated policies.

The Third Approach

In the model company, policies issued in any given year will leave a permanent contribution to company surplus after they have all terminated. This contribution can be viewed as the "cost of capital." We can divide this contribution into two parts: the first part relates to the capital required at various durations to maintain the 5 percent surplus ratio, and the second part is a special contribution required to build surplus up to the required level, 5 percent of reserves.*

We measured the first part of the capital contribution at each duration for policies issued in a given year as a percentage of the capital used, which was defined as the excess of (a) over (b), where (a) was the sum of the statutory reserves plus the dividend liability plus the required surplus in the model (5 percent of statutory reserves), and (b) is the assets accumulated by in-force policies under Approach 3. The first part of the capital contribution approximates an annual contribution of 5.6 percent to 5.7 percent of existing capital.

Under Approach 3, the cumulative capital contributions are determined at the time a policy terminates and added to the terminated policy category; the resulting surplus/deficit on terminated policies is credited/charged to in-force policies.

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*We can measure the special contribution as the after-tax gain derived from the difference between the lower dividend scale actually paid in the first 40 years and the almost 15 percent higher dividend scale which the company could afford to pay after it had built its surplus up to the required level.

Line 6a of Table 5-1 shows the accumulated assets from terminated policies under Approach 3, $286.0 million, of which $7.0 million is attributable to the special contributions to capital made in the first 40 years by policies now terminated. If the company were not to convert, the policies in force would have accumulated capital costs of $177.1 million, as shown on Line 6a. Such policies would have generated an additional $2,107.2 million assets needed to mature the policies and pay future capital costs, as shown on Line 6b. In total, as shown on Line 6c, the assets with respect to in-force policies are $2,284.3 million.

Because few mutual companies will have had over the years a clear philosophy of capital charges reflected in their pricing, dividend and benefit structures, most companies wishing to employ Approach 3 will have to develop a measure of the cost of capital charges implicit in the actual pricing, dividend and benefit structures. This could be done by analyzing the relationship of the observed experience to the dividend factors over an extended period of time and developing a capital charge structure which reflects these relationships and approximates the observed financial results.

The numerical results in the table are sensitive to the assumptions and product design of the model and should not be used without careful analysis.

Technical Note

It is interesting that the 5.6 percent to 5.7 percent charge for the cost of capital can be derived by general reasoning as follows:

The growth rate was 8 percent in the model company. Once the company has reached a steady state (that is, once the policies from the first issue year with the youngest issue age reach attained age 100), one can analyze the ongoing cost of capital as the excess of the growth rate in surplus needed to maintain the ratio of surplus to reserves over the net after-tax interest rate earned on surplus, which is the rate at which surplus can grow without any capital cost contributions from in-force policies. The latter rate is just over 2.3 percent for the model company (because it pays the equity tax as well as a 36.8 percent tax on gains), so the cost of capital is between 5.6 percent and 5.7 percent of the capital used, once the company has reached a steady state. The cost of capital charges is accumulated at the same 2.3 percent.

3. THE ASSUMPTIONS ABOUT HISTORICAL EXPERIENCE TO BE USED IN CALCULATING ASSETS ACCUMULATED WITH RESPECT TO A POLICY OR CLASS OF POLICIES

The mortality assumption in the life insurance asset accumulation should reflect pooling of mortality risk because this is a risk from which the life insurance policyholder received protection. Mortality pooling on immediate annuity contract holders (the benefit of survivorship) also seems appropriate.

The asset accumulation should use investment rates of return based on the net investment income and net realized capital gains (losses) as allocated using the company's historical accounting methods. Consistent methods also should be applied to any unrealized capital gains (losses) included in admitted assets.

The recognition of policy loans may be directly to the policy, to the policy form or just to the line of business. The Task Force believes that prior year-by-year company practice in dividends should be a guide.

The cost of traditional reinsurance ceded (premiums paid less claims recovered) may be assessed either just against reinsured policies or against the whole block, depending on the equities as perceived by the actuary, as well as on practical considerations. Similar approaches may be taken with respect to internal reinsurance.

The asset accumulation may ignore large, one-time gains or losses not truly attributable to classes of policies to be placed in the closed branch, such as guarantee fund assessments, catastrophes, tax effects or bulk reinsurance, or a fund transfer between lines of business approved by the state regulators in years past. An example of the last item is a line of business which was shut down after accumulating a loss. To eliminate allocations of increasing amounts of negative investment income to that former line of business, the company may have transferred funds from another line to eliminate the negative surplus. In these circumstances, it is reasonable to assume that the dividends in the surviving line were smaller than they would have been without such transfer, and that the asset accumulations for that line should thus reflect both the lower actual dividends and the transfer of funds as a charge. Ideally, past dividend practices should govern, but it may be difficult in practice to decide whether or how to reflect in the asset accumulations one-time events for which there is no clear record of the results on the dividends paid.

The asset accumulation might include a credit for gains or riders such as accidental death or disability premium waiver. The question is whether it is fair, practical or consistent with prior dividend practices to credit such rider gains to all policies or only to those policies with such riders.

The asset accumulation might include a credit for gains on dividend options not paid in cash. Again, the question is who gets such credits. For example, all policies could get some credit, or gains on paid-up dividend additions could be credited only to those policies currently having such additions. Past dividend practices should govern.

Charges to the asset accumulation for federal income (and other) taxes should follow historical allocation methods (or the tax charge in the dividend formula if an explicit tax charge has been consistently made).

The asset accumulation for participating lines should include a credit for gains on nonparticipating lines (perhaps in subsidiaries), at least to the extent these gains were reflected in past dividend practices.

Charges to the asset accumulation for commissions, premium taxes, other state taxes, investment expenses and administrative expenses are straightforward contractual or traditional allocations except to the extent certain issue expenses are capitalized and then amortized over time.

APPENDIX 6

DETERMINATION OF POLICYHOLDERS' CONTRIBUTIONS FOR POLICIES NOT INCLUDED IN A CLOSED BRANCH

Policyholders' contributions for participating policies not included in a closed branch should be determined on a basis consistent with determinations for policies within a closed branch. As stated earlier in the report, the Task Force recommends that such determinations be based on the excess of

1. the amounts of assets accumulated in the company with respect to the policies including any amounts derived from implicit or explicit capital charges, less
2. the amounts required, with future premiums to mature the policies and to pay dividends on a basis consistent with preconversion practices.

Determinations of assets accumulated for policies not included in a closed branch involve most of the issues raised in Appendix 4 with regard to policies within a closed branch.

In the particular case of group policies for which the company maintains policy-level experience funds for determining dividends, (1) may be derived from the experience funds adjusted to restore any deductions from the experience funds before the conversion date that were in the nature of capital charges.

As described in Appendix 4, restoration of past capital charges may be the most difficult issue to be resolved in determining (1). Past capital charges may have been made explicitly through identifiable risk charges or contributions to surplus, or may have been made implicitly, for example, through conservative experience charge or credit factors. If the implicit approach was used, determination of the amount of such risk charges or contributions to surplus may pose practical difficulties.

Whether explicit or implicit, risk charges or contributions to surplus were probably made in the past partly to fund identifiable current and past losses from other policies of the class or from other classes of policies and, therefore, only partly to accumulate capital for the company. To the extent that the amount of risk charges or contributions to surplus used to fund past losses can be documented and identified as such, that amount need not be restored to experience funds in the determination of (1). Any remaining portion of past risk charges or contributions to surplus, however, should be treated as past capital charges and restored to the policyholder experience funds in determining (1).

Determination of the amounts required, (2) above, for policies not included in the closed branch might be based on the statutory reserves and liabilities, provided that statutory reserves and liabilities are sufficient to provide for current scale dividends as well as contractual benefits.

Where the company maintains policy-level experience funds for determining dividends, (2) may be derived from the experience funds.

Chairman **Rangel**. Anyone seeking recognition? Mr. Vander Jagt.

Mr. **Vander Jagt**. Thank you, Mr. Chairman.

Mr. Schuenke, I think you would agree that at least the segment balance part of the 1984 act changes was a terrible mistake. That was the gist of your testimony, wasn't it?

Mr. **Schuenke**. That was part of it.

Mr. **Vander Jagt**. I also gathered from what the prime mover of that reform said that the mutuals at that time agreed to the segment balance formula?

Mr. **Schuenke**. That's correct.

Mr. **Vander Jagt**. Mr. Harman, the mutuals testified that their effective tax rate is twice as high as the effective tax rate on the stock.

Is that correct?

Mr. **Harman**. We do not think so, Mr. Vander Jagt.

Mr. **Vander Jagt**. Is it higher?

Mr. **Harman**. No, we believe that the stock segment has a higher effective tax rate. The numbers, at least as I understood them, Don, in your testimony were based on annual statement data.

We believe that if you use the data contained in the Treasury Department study you get different results depending upon which line you look at.

The gain from operations of mutual companies for the 2-year period was about $25 billion. If you said they had no deduction for their payments to their stockholders, then you would get an effective rate of under 10 percent; $2 billion in taxes paid yields an effective tax rate of less than 10 percent.

If you look at it after they paid all their dividends, which I believe may have been around $22 billion, then you would get a higher effective rate.

The effective rate of a mutual company depends upon what gain from operation number you use. If you do it without any deduction for policyholder dividends, you get a very low rate; if you do it with 100 percent deduction, you can get a very high rate.

Somewhere in between is probably the right answer. Some of their dividends should be deductible, and some not. That has been the whole question since 1909.

Mr. **Schuenke**. Congressman, could I add to that?

Mr. **Vander Jagt**. Of course.

Mr. **Schuenke**. Bill is right in his analysis, and reasonable minds could differ about the extent of the dividend that ought to be deducted. No one has ever suggested that none of the dividend should be deducted.

Our goal in the chart was to try to put the stocks and the mutuals on an equal basis, under either an annual statement conventional basis or on a restate basis, and this is clear in the written testimony—our effective tax rates are still about twice theirs.

Chairman **Rangel**. Mrs. Kennelly.

Mrs. **Kennelly**. Yes, thank you.

Mr. Harman, since you seem to think that the 1984 act is working, do you think it would be appropriate at this time to have 100 percent consolidation between life insurance companies and nonlife companies?

Mr. Harman. Yes, I do, Mrs. Kennelly. That is the rule for all other corporations; 100 percent consolidation. And I think once the Congress has satisfied itself that life insurance companies are on a total income basis, then it is quite appropriate and fair, because you should treat the life insurance company the same as any other corporation.

So my short answer is, yes, we support that.

Mrs. Kennelly. Just quickly, Mr. Chairman, since we have heard that taxes might be off for one segment, is there any feeling, or do you see this reflected in the marketplace?

That was the concern that we kept coming back to in 1984, where we could talk in an esoteric way about segment balance rather than what is happening. But in fact, do you see a concern in the marketplace?

Mr. Schuenke. I'm not sure I can answer that. But if there is some kind of break between stocks and mutuals or some competitive advantage, I think it's clear from the testimony and the material that's been filed that the stock segment of the life insurance industry is growing much faster than the mutual segment.

Mrs. Kennelly. Thank you, Mr. Chairman.

Chairman **Rangel.** Mr. McGrath.

Mr. McGrath. Thank you, Mr. Chairman.

I've read over most of these statements prior to coming here. My judgment here is that this is an interim report and this is an interim hearing. It appears to me that we have a long way to go before we make any judgments as to the validity of either side of this particular issue.

Given the circumstances as they exist, I think that we need a lot more information before we can prepare any legislative proposals or recommendations.

I'd be interested in seeing what the Treasury suggests in its report that is due by the end of this year or early next year.

I have no questions, Mr. Chairman. But I just wanted to say that I think we have a long way to go.

Thank you.

Chairman **Rangel.** Thank you.

I'm certain that if Mr. Harman and Mr. Schuenke got together, they could come up with a solution.

But let us take a 10-minute break. And then we will conclude by listening to Professor Graetz.

[Brief recess.]

Chairman **Rangel.** The subcommittee will come to order. Mrs. Kennelly.

Mrs. Kennelly. Thank you, Mr. Chairman. I understand that in my absence the McIntyre report was alluded to and various companies were mentioned as not paying taxes. I just would like to make mention of the fact that one of those companies is within my district, the Aetna, which, of course, I think I've been told correctly has paid $17 million in taxes, that there has been a mistake made.

However, I would like to place an insert on the subject in the record.

[The information follows:]

Ætna LIFE & CASUALTY **NEWS** *For Release:*

Contact:

Elizabeth Krupnick

Sept. 22, 1988

203/273-6620 (work)
203/677-6150 (home)

HARTFORD, Conn. -- Responding to a report issued by the Citizens for Tax Justice, Aetna Life & Casualty said it paid $17 million in federal income taxes in 1987 and called its inclusion in the report as a non-taxpaying corporation erroneous.

Aetna said the amount the company paid in 1987 was unusually low. For example, in 1985 and 1986, it paid federal income taxes of $107 million and $121 million, respectively.

Aetna said remaining net operating losses in its property and casualty businesses and increased reserves for its new guaranteed pension business substantially reduced the company's tax liability in 1987 below the levels of prior years. Aetna also said that, as a result of the Tax Reform Act of 1986, the company's property and casualty operations expect to report substantially higher levels of taxable income in the future.

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Chairman Rangel. Mr. Downey.

Mr. Downey. Mr. Chairman, Professor Graetz has already spoken, I take it.

Chairman Rangel. No, he has not. I thought you may want to respond to Mrs. Kennelly.

Mr. Downey. No.

Chairman Rangel. All right, Professor Graetz, thank you so much for being with us. The professor, as most people know, is from New Haven, Connecticut, and is a professor of law at Yale Law School.

Your entire statement, by unanimous consent, will be entered into the record, and you can summarize your statement and proceed as you feel most comfortable.

STATEMENT OF MICHAEL J. GRAETZ, JUSTIS S. HOTCHKISS PROFESSOR OF LAW, YALE LAW SCHOOL

Mr. Graetz. Thank you, Mr. Chairman.

It is a pleasure to be here today. I am not a veteran of the 1984 legislation. I was first asked to look at this issue by the Metropolitan Life Insurance Company after that legislation passed. And my analysis took place subsequent to that legislation.

I certainly do not intend that anything I say today be taken as a criticism of that legislation. I think it is a lot easier to analyze a provision of this sort with the benefit of hindsight, than it is to try to figure out the right answer under the pressures of legislating, and in light of the history of the dispute to that point with this industry.

At the outset, I would like to express my basic agreement with views that I have heard expressed here today by everyone who has testified: the Treasury, the GAO, Professor Pike, the stock and mutual groups; and that view is, that each company's taxation should be based on its economic income.

I think that that is the goal that this committee should set for itself, and that the legislation which emerges—whenever it emerges, after all the studies have been completed, should be directed toward that goal.

That goal suggests that any view of segment balance that is not grounded in economic income is at best a second measure, and at worst, should be avoided under any circumstances.

It is strange, in my experience, indeed unique in dealing with the tax law—to have a provision that tries to tax an industry based on one segment's taxes versus another segment's taxes. And in particular, with respect to the mutual companies at least, this provision bases their taxes on the economic performances both of stock companies and other companies in the mutual industry.

So that the appropriate goal, it seems to me that we're all in agreement with, is to try and measure economic income of both stock and mutual companies.

Section 809, about which we've heard a good bit today, I think resulted because Congress and others concluded that in the case of a mutual company, it was simply impossible to measure economic income; that although we knew how to do that with respect to stock companies, we did not know how to do it with respect to mutual companies. The basic judgment that was made looked at only one piece of the differences between stock and mutual companies, namely, that stock companies are not allowed to deduct dividends to shareholders.

It was then assumed that if policyholders are in fact equivalent to shareholders in a mutual context, that mutual companies should not be allowed to deduct their returns to their policyholders.

What my analysis does is to step back from looking at this annual snapshot at the moment of the payment of the dividends and ask the more fundamental question of whether in the natural course of events the economic income of stock and mutuals will be measured properly, even if mutual companies are allowed to deduct the portion of dividends paid to policyholders, which fairly can be characterized as the equivalent to equity returns in the stock context.

I assumed for my analysis that the payment of dividends to the policyholders as a return on equity supplied through premiums was the equivalent of a return on an ownership interest, and I avoided the age-old question of trying to divide the portion of capital received by mutual companies into ownership, elements, or the equivalent of debt or overpayment of premiums.

I looked at this problem from this broader and different perspective, one which I must say is new in the academic and staff literature. This method of looking at the time value of money over a longer period is one that really first took hold in the Congress in the 1984 act, elsewhere than in the life insurance provisions in the accounting provisions in particular. And this was a method of analysis that had been developed by the Treasury Department in its study of how one might implement a consumption tax, and in other contexts.

But it was a new way of looking at life insurance company taxation, and the basic methodology was to say: let's try and equalize the burden of taxation in present value terms over time, but let's not worry about annual deviations in the pattern of collections from one person or another or in one method or another of collecting taxes over that time.

The analysis, which is set forth in my paper, which I'm prepared to submit for the record or make available to the committee, was published following a conference in which it was the principal paper, at Yale University in March of 1986. The analysis says that under a reasonable set of assumptions—namely, that stocks and mutuals earn the same rate of return and are taxed at the same tax rate—if premiums are taxed as they come in on the mutual side, allowing a full deduction for policyholder dividends, will produce a tax precisely equivalent to the tax that would be produced on a stock company from the classical corporate tax rules, which do not take into account income capital which is contributed from shareholders, and do not allow a deduction for dividends.

It turns out that if either of those assumptions are false, if the rates of return are different, if tax rates are different, then you will get some disparities in this equality; it will not be perfectly equal. But there is no reason to think that either of those two assumptions produces a systematic difference one way or another.

I think that the analysis has been captured well by an analogy to the method of collecting fares on streetcars. There are some streetcars that collect the fare when you get on the streetcar, and there are other streetcars that collect the fare when you get off the streetcar. And in the case of mutual companies, the tax is paid when the premiums are received and counted as income, and in the case of stock companies, the tax is paid when the deduction is denied for dividends.

A section 809 kind of adjustment, which denies deduction for policyholder dividends, will tax mutual companies essentially both when you get on the streetcar and when you get off the streetcar; and I think that that's analytically incorrect.

What my analysis suggests is that Section 809 was built on a fundamental analytical misconception, and that the Congress, therefore, should reexamine this provision to determine whether or not economic income of mutual companies can be measured over time in a proper way.

The 1984 act's decision, its fundamental decision, that the tax should be based on economic income, is a major move in the right direction. And if you impose tax on economic income over time, you will tax both mutual and stock companies properly.

It is worth noting that this analysis inherently suggests, and it's not just this analysis—the method of taxing mutuals as compared with stocks—suggests that the questions that this committee is looking at are in some ways the wrong questions.

That is to say, that it is wrong to look on an annual basis to see how much taxes were paid either by the stock companies or the mutual companies, and make some comparison of them because they are basically taxed in different ways.

Mutual company taxes will depend on the amount of premiums they collect; the amount of redundant premiums they collect as capital from their policyholders and stock company taxes will turn on how much dividends they're paying.

To look at an annual slice is going to give an answer that is not consistent with the basic goal, which is to tax economic income over time.

The basic question of inquiring about annual snapshots of revenue of mutual and stock industries, it seems to me, is not the question that this committee should be addressing. There seems to be universal agreement among the witnesses that have testified here today that looking to some other measures—assets, premium, equity, whatever it might be, as a basis for an income tax, which is done in this industry—and as I say, I know of no other case where it is done this way—is not sound tax policy. We ought to try to impose tax based on economic income, and we ought to try to measure economic income.

There have been a few questions raised here today about my analysis by Professor Pike, both of which are covered in my longer paper.

As he has mentioned, one of them is that prior to 1984, under 1959 law, or 1909 law, or 1928 law—I'm not sure which—but at some point that mutual companies were not taxed on their premium income. This suggest that section 809 can now be justified because of something that had happened in the past.

This has been labelled a transition issue. I suppose I'm the one guilty of labelling it that way.

The point I would now make is twofold. First, there is a real empirical debate about what happened during the period prior to 1984. And as my statement indicates, I know that John Nolan of Miller and Chevalier has tried to come up with some answers to that. And his analysis, at least, suggests that there were adequate taxes paid by mutuals during that period.

Second, to the extent that you're worried about a potential competitive advantage looking ahead, to the future, if premiums are taxed at the margin to mutual companies, there will be no competitive advantage that I can see.

Third, this transition notion was not the rationale originally given for enacting section 809. The rationale was that it was necessary to put dividends to policyholders and dividends to stockholders on an even playing field to preclude future competitive advantage. If there is some transitional problem that exists, then it ought to be analyzed separately and addressed as such.

I guess I would say pretty much the same about the policyholder level issue which Professor Pike mentioned. He said that in 1984 they came up with some number in section 809 that was designed to compensate for a difference between the policyholder tax at the individual level, and the shareholder tax on dividends at the individual level. My paper suggests that there is an individual level difference; policyholders are not taxed on their ownership returns in the same way that shareholders are taxed.

But again, if the problem is at the individual level, then there ought to be an assessment made of precisely what the problem is. Pension funds, for example, are taxed exactly the same. They are not taxed whether they receive shareholder dividends or policyholder dividends.

So there is some additional analysis that needs to be done to see what kind of policyholder level tax, if any, is appropriate. I know there are disputes about that.

In sum, what I am really suggesting is that I think that section 809 is a provision which is complex. And is unfair, because it does not tie any individual mutual company's tax to its own economic income.

It almost certainly will create inefficiencies in operation of the sort that the GAO alluded to today. To the extent that we now have new justifications for this 1984 provision, we ought to go back and try to match any provision with the current justifications.

That means that section 809 merits a comprehensive reexamination by the Congress.

I have to say that as Professor Pike was sitting here and said he would give section 809 a B-plus, I would probably give it a B-plus, too. But at Yale, a B-plus would not be a very good grade. Like the dollar, we've suffered a lot of inflation in New Haven. So he and I might grade it the same, but the meaning might well be different.

The only other thing I would like to add to my testimony is that in sitting and looking at Professor Pike's testimony—and this point will be of help, I think, at least to the staff as they try and work through these numbers—if you look at the table, the example at the end of his prepared—and I have not worked completely through the example—but if you look at the example in Professor Pike's testimony, at point No. 1 he says that each insurance company has equity of $1 million. That's where he starts.

If that equity comes from shareholders in the form of contributed capital, all they need to do is contribute $1 million to have $1 million of equity in the stock company.

In a mutual company, if this equity is contributed in the form of premiums, redundant premiums that will be included in income and taxed at a marginal rate of 34 percent, then the policyholders will have to contribute according to my numbers, $1.515 billion of equity, contributed by policyholders, as premiums when the premiums came in, they would be included in income. They would be subject to a 34 percent tax. And after paying roughly $500,000 in tax, the mutual company would then have its million dollars of equity.

What is ignored in this analysis, which I deal with in my analysis, is the half a million dollars of tax on premium income. That's the prepayment of tax. That is the prepayment of tax on mutual companies that I am referring to in my testimony, and in my analysis.

There is a footnote, I think, in my paper, that goes through this kind of example as well. But I did want to mention that I think that is really the difference in .the two methods of analysis; I am looking at it as the capital comes in from the beginning over time, and Professor Pike is looking at it in a one-year snapshot taking the events as they sit at that time.

[The statement of Professor Graetz follows:]

TESTIMONY OF
MICHAEL J. GRAETZ,
Justus S. Hotchkiss Professor of Law, Yale Law School,
BEFORE THE SUBCOMMITTEE
ON SELECT REVENUE MEASURES
OF THE WAYS AND MEANS COMMITTEE,
United States House of Representatives,
ON THE SUBJECT OF
TAXATION OF LIFE INSURANCE COMPANIES

September 27, 1988

Mr. Chairman and Members of the Committee --

It is a great pleasure to appear before you today to testify on the subject of taxation of mutual and stock life insurance companies. I am appearing today at the request of Metropolitan Life Insurance Company which has asked me to share my views with you.

At the outset, let me express my strong general endorsement of the Life Insurance Company Tax Act of 1984. The 1984 Act marked the abandonment of mechanisms of prior legislation that had taxed life insurance companies under specially-designed tax regimes that sometimes had seemed more closely aligned with excise than with income taxes and at other times had involved complex multi-phase income tax systems which varied companies' tax burdens depending upon the source or character of income they received. In 1984, Congress properly concluded that life insurance companies, like corporations in other industries, should be taxed based upon their economic income. In attempting better to measure economic income of life insurance companies, the 1984 Act appropriately eliminated or revised a variety of noneconomic and arbitrary tax provisions.

The 1984 Act, therefore, marked the end, I hope, of the prior Congressional view that life insurance companies' methods of making profits were so unique that fundamental principles of income taxation could not be applied to them. The corporate tax system will be served best if future legislation on the subject of life insurance company taxation embraces the fundamental principle established by the 1984 legislation -- viz, that economic income is the proper tax base -- and evaluates legislative proposals to determine how well or how poorly they serve that principle.

I have studied in depth one provision of current law, and that provision, in my view, represents an unfortunate departure from the basic principle that life insurance company taxes should be grounded on a determination of each company's economic income. That provision is section 809 of the Internal Revenue Code, the provision which adds a so-called "differential earnings amount" to the income of mutual life insurance companies.

I should begin my discussion of Section 809 by confessing that, although I have worked closely with this Committee on many occasions both formally and informally in the past, I have never before been involved in a subject as bizarre as the one we are dealing with here today. I am a relative newcomer to the subject of taxation of life insurance companies, having first become involved with this subject shortly after the passage of the Life Insurance Company Tax Act of 1984, when the Metropolitan Life Insurance Company asked me to undertake a study of Section 809. I played no role at all in the development either of the 1984 legislation or any of the life insurance company tax provisions that preceded the 1984 Act.

To be candid, Mr. Chairman, as I began analyzing this provision my initial reactions were of puzzlement and mystery.

The Internal Revenue Code, to be sure, is filled with many strange looking animals, but none, I think more unusual than Section 809. As I studied the matter, I came to understand that the existence, as well as the details, of this provision can only be explained as an outgrowth of many long years of internecine warfare between the stock and mutual segments of the life insurance industry. Understanding Section 809's evolution, however, does not erase its peculiarity.

Section 809 is a tax provision that, in essence, says to a mutual life insurance company: First, compute your taxable income. Second, determine an imputed rate of return for a group of the largest stock life insurance companies. Third, discover the average rate of return of all mutual life insurance companies and subtract that number from the stock number. These calculations produce something called the "differential earnings rate." That number is then multiplied by each mutual company's "average equity base" to determine a "differential earnings amount". This amount is then added to the income of mutual life insurance companies (technically by reducing otherwise allowable deductions).

As even this brief summary suggests, section 809 is a unique provision of great complexity and uncertain and controversial administerability. How did such a provision come to be enacted?

Section 809 resulted, I think, from two mistakes in 1984. The first was a policy decision -- the decision that it was good tax policy to attempt somehow to achieve a certain prearranged distribution of the life insurance company tax burden between the stock and mutual segments of the industry, to achieve something that has become known as "segment balance". In all other industries, the tax burden is generally distributed in accordance with each company's own economic performance, and, in principle at least, that burden will be allocated based on each company's economic income. Of course, as this Committee is most acutely aware, issues of how to measure economic income are extremely controversial in many industries. But nowhere else in the Code do I know of an effort to attempt to distribute the burden of the corporate income tax based on a company's or group of companies' or a "segment's" assets, sales, capital or any feature other than income. Section 809 represents such an effort and that effort should be abandoned.

So long as the Congress attempts to distribute the tax burden on such a basis, one company's taxes will always and inevitably depend on the performance of its competitors, competitors both within its same segment of the industry and within the other segment. No company's taxes will depend solely on its own economic performance and no company will be able to plan for its taxes without attempting to predict the performance and planning of its competitors. Tax burdens will always be based on some arbitrary measure, and the detail of the law will always depend upon the outcome of contests of pure political power. Debates will rage over how much taxes were paid under this or that arbitrary provision and over how much would be paid under a different one.

As an historical matter, I think the attempt to achieve "segment balance" is understandable. It was assumed that although classic corporate tax rules provided guidance in determining the economic income of stock companies, the economic income of mutual companies could not be determined on an equivalent basis. This led to the conclusion that it would be appropriate to resort to "segment balance". But, an effort to measure, achieve and maintain "segment balance" in life insurance company taxation, such as is now occurring, will necessarily ultimately prove the undoing of the fundamental decision to base the taxation of life insurance companies on economic income.

Congress was correct in 1984 that the tax burden of life insurance companies, like that of other companies, should be distributed in accordance with each company's economic income. A tax based upon economic income will automatically achieve the proper "balance" based upon economic performance both among companies within a given segment of the industry and across the stock and mutual segments. The mission of Section 809 somehow to produce some other appropriate "segment balance" is a misguided enterprise and should be abandoned.

Secondly, the adjustments required by section 809 also were, I think, the product of a mistaken belief that they were necessary to reflect the economic income of companies in the mutual segment of life insurance companies. My detailed analysis of Section 809 suggests that its justification as a necessary adjustment to equate distributions of capital of mutual and stock life insurance companies is fundamentally flawed. I can only summarize my conclusions for you in my testimony today, but the basic analysis is set forth in my paper, "Life Insurance Company Taxation: An Overview of the Mutual vs. Stock Differential," which along with other related papers were published in Life Insurance Company Taxation: The Mutual vs. Stock Differential (M. Graetz ed., 1986, Rosenfeld Emmanual, Inc.), after having been presented at a conference held at the Yale Law School in March, 1986. I, of course, would be happy to make copies of that paper available to members of this committee or to your staff.

In general, the addition to taxable income of mutual life insurance companies required by Section 809 was designed by Congress to redress a perceived competitive advantage. Congress apparently believed that such an advantage would otherwise accrue to mutual companies as a result of differences in the way mutual and stock companies raise capital and pay returns to those who supply that capital.

Stock life insurance companies are organized in the ordinary corporate manner. They borrow from other financial institutions and from bondholders, and shareholders supply equity capital and are the owners of the company. Shareholders of stock life insurance companies receive typical shareholder returns in the forms of dividends and capital gains on the capital they contribute to the enterprise. Classical corporate tax rules apply to a stock life insurance companies. Loans through the sale of bonds or otherwise are not considered income to the company and interest paid on debt is deductible. Shareholder contributions of capital are also not considered taxable income to the stock company. On the other hand, stock companies are not permitted any deduction for shareholder dividends.

In contrast, mutual life insurance companies have no shareholders. Mutual companies get their capital from policyholders through charging policyholders so-called redundant premiums.* This source of capital is taxed as premium income. Absent any special adjustment, all amounts transferred by the policyholders to the company would be included in company income, and all policyholder dividends would be deducted by the company. Therefore, although profits retained by the companies (retained earnings) are taxed on the same basis to both stock and mutual companies under an economic income tax base, contributed capital and returns distributed as dividends on that capital are naturally treated differently.

At bottom then, the perceived need for an adjustment to taxable income of mutual life insurance companies, such as that contained in Section 809, resulted from a simple analogy between mutual company dividends to policyholders and stock company dividends to shareholders. If the former are deductible, while the latter are not, mutual companies were thought to enjoy an undue tax advantage that might translate into a competitive advantage in the market for life insurance products. The 1984 committee reports make it clear that Section 809 was intended, at least in part, to redress any such potential advantages. No consideration was given to the effect of the mutual companies' disadvantage resulting from the taxation of mutual company receipts of capital.

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*The term "redundant premiums" as used in this testimony means the portion of a mutual company life insurance premiums, in addition to that which otherwise might be required to provide life insurance, that represents capital received from policyholders.

The detailed analysis of my paper demonstrates that under a reasonable set of assumptions -- that stock and mutual companies are subject to the same constant tax rate and earn similar rates of return -- a tax on economic income that includes in income of mutual companies capital received from policyholders in the form of redundant premiums and allows a full deduction of policyholder dividends will burden mutual companies in a manner identical in present value to the tax burden of stock companies. The present value effect is exactly the same as excluding shareholder contributions of capital from income and not allowing any deductions for shareholder dividends. This means that although mutual and stock companies are naturally taxed differently, when one looks at the overall effects over time -- rather than focussing solely on a moment of payment of dividends to shareholders or policyholders -- a tax on the economic income of each, without any section 809-type adjustment will produce an equivalent tax burden on mutual and stock companies in terms of the present value of taxes paid. This equivalence occurs regardless of the timing of premiums or distributions of policyholder dividends. Two relatively simple examples demonstrating this point are set forth at the end of this testimony.

My analysis -- which has been labelled the "prepayment analysis" since mutual companies "prepay" a tax when they receive redundant premiums precisely equivalent in present value to the tax paid by stock companies when they distribute nondeductible dividends to shareholders -- further shows that mutual companies are naturally disadvantaged in the present value of their tax burdens relative to stock companies with respect to the component of policyholder dividends that is equivalent to an "interest-type" return to bondholders of the stock company. Redundant premiums representing capital received as loans is included in mutual company taxable income, but loans to stock companies from bondholders is excluded from stock companies' income. To the extent that mutual companies borrow from policyholders in this way, a tax on economic income with full deduction for policyholder dividends favors stock companies, not mutual companies.

The basic point of my analysis has been made simple by comparison to two different methods of collecting streetcar fares. Some streetcars collect the toll at the end of the ride -- this is what happens when dividends to shareholders are denied deduction by stock companies. Other streetcars collect the toll when at the beginning of the ride -- this is what happens when redundant premiums are taxed to mutual companies. Under present life insurance company tax law, which includes Section 809, mutual companies are taxed twice -- both at the beginning and at the end of the ride. This system surely merits a complete reexamination by the Congress.

The prepayment analysis marks the end of the notion that there is some special difficulty in taxing the economic income of mutual, as opposed to stock, companies in the life insurance industry. A proper balance among companies as well as between segments, based upon economic income, is both feasible and wise policy.

My analysis also offers an additional reason why it is mistaken tax policy to attempt to impose tax on mutual and stock life insurance companies by attempting to impose "segment balance". Looking to any measure of "segment balance" -- the share of taxes paid by the mutual and stock segments of the life insurance industry -- on an annual basis or, indeed at any moment in time, necessarily will present a misleading picture. My prepayment analysis demonstrates that while the present value of tax burdens on equity capital of stock and mutual companies will be equivalent, their pattern of tax burdens may be very different over time. The different methods by which stock and mutual companies would naturally pay equivalent taxes in present value under a tax imposed on economic income render annual snapshots of "segment balance" misleading as an evaluative tool.

My prepayment analysis of the mutual-stock life insurance company tax issue involves the application of a recent understanding of the importance of looking at tax consequences over time rather than at one instant in time. Comprehending and legislating a tax system that responds to time-value-of-money concepts in its wide range of contexts is no easy task, and it is surely no surprise that this analysis had not been developed when Congress last considered this issue in 1984. All I have done essentially is to apply our relatively new understanding of time-value-of-money concepts to the age-old question of the appropriate taxation of mutual and stock life insurance companies.

I have subjected my analysis to scrutiny by a number of experts in the field, both at the March 1986 Yale Conference and subsequent to its publication. There seems to be general agreement that the prepayment analysis is sound. Because of mutual companies' "prepayment" of tax on redundant premiums, the asserted company-level advantages due to mutual companies' deduction of policyholder dividends simply does not exist in the manner described by Congress in its 1984 legislative history of Section 809 so long as economic income is taxed to life insurance companies under a single-phase company-level tax imposed at an identical stock and mutual company tax rate. This means that the principal rationale offered heretofore by the Treasury and in the committee reports disappears as an appropriate justification of section 809.

Some people have raised what has become known as a "transition" issue -- that some adjustment like Section 809 is necessary to redress inadequacies of pre-1984 law. Congress in 1984 did not enact Section 809 to address a "transitory" issue. Section 809 was enacted on the assumption, which I have demonstrated to be false, that some adjustment of mutual companies' tax base was inherently necessary to measure the economic income of a life insurance company organized in the mutual, as opposed to stock, form. The so-called transition issue has been addressed in a paper by John S. Nolan of Miller and Chevalier, which analyzed this issue both from a policy perspective and empirically based upon data of the American Council of Life Insurance. Mr. Nolan concluded that capital received by mutual companies was effectively taxed under prior law and that no transition problem exists. Mr. Nolan's analysis seems basically sound to me.

Section 809 is a provision characterized by complexity, unfairness and inefficiency in operation. Even if other problems remain between mutual and stock life insurance companies, due, for example, to such things as differences in treatment of shareholders and policyholders under the individual income tax, this Committee should not allow such new rationales to serve as an *ex post* justification for retaining Section 809 in its present form. Section 809 merits a comprehensive reexamination by the Congress.

Examples of The Prepayment Analysis

Example 1

Allowing a full dividend deduction for mutual companies achieves tax equivalence with stock companies:

		Mutual Company	Stock Company
1.	Infusion of Capital	$100	$100
2.	Tax on Capital: 34%X(1) (Mutual Company only)	34	0
3.	Capital on Hand:(1)-(2)	66	100
4.	Pretax Return: 10%X(3)	6.60	10
5.	Tax on Earnings:34%	0	3.40
6.	Returns on Capital		
a.	Deductible Policyholder Dividend	6.60	0
b.	Non-deductible Shareholder Dividend	0	6.60

As the above example demonstrates, the mutual company's ability to pay "ownership dividends" is limited because the capital is subject to a prepayment of tax and is 66% (1-.34) of the capital of the comparable stock company. This tax detriment continues even if earnings on capital are retained by the companies. As the following example shows, the ratio of stock company equity to mutual company equity remains the same (100:66) as earnings are retained.

Example 2

Retained earnings of stock companies and mutual companies are taxed similarly. Tax equivalence is achieved even if earnings are retained for a number of years before payout.

		Mutual Company	Stock Company
YEAR 1			
1.	Infusion of Capital	$100	$100
2.	Tax on Capital: 34%X(1) (Mutual Company only)	34	0
3.	Capital on Hand:(1)-(2)	66	100
4.	Pretax Return: 10%X(3)	6.60	10
5.	Tax on Earnings:34%	2.24	3.40
6.	Retained Earnings: (4)-(5)	4.36	6.60
YEAR 2			
7.	Capital on Hand:(3)+(6)	70.36	106.60
8.	Pretax Return: 10%X(3)	7.04	10.66
9.	Tax on Earnings:34%X(7)	0	3.62
10.	Returns on Capital		
a .	Deductible Policyholder Dividend	7.04	0
b .	Non-deductible Shareholder Dividend:(8)-(9)	0	7.04

Therefore, the Prepayment Analysis holds and equal present value tax payments will occur regardless of the timing of premiums or distribution of policyholder dividends.

Chairman RANGEL. Thank you, Professor.

Your analysis, was that done at the request of Metropolitan Life Insurance?

Mr. GRAETZ. I'm delighted to have an opportunity to answer that question, Mr. Rangel.

When I work for free, I work on the low income housing tax credit. I am really interested in that provision, and I've spent a lot of time working on it of late.

I would not have looked at insurance taxation, being an academic and not having to look at things that I don't want to, had somebody not requested me to look at it and paid me to look at it.

The Metropolitan Life Insurance Company said to me after the 1984 act was passed, "Will you look at this provision and tell us what you think of it?" I did this analysis under those conditions.

It turns out that my analysis was one that they agreed with. I suspect—I don't know what would have happened; I don't suppose I'd be here today—had my analysis be one that they did not agree with.

But I do want to make it clear that there has never been any effort by them to affect either my analysis or the presentation of the basic assumptions that go into that analysis. We had a conference where I presented this analysis—Henry Aaron of the Brookings Institution who was very much involved in this issue before was there, and he basically said the analysis was correct.

Two former deputy assistant secretaries of the Treasury were there, one in the Carter Administration and one in the Reagan Administration—Dan Halperin and Greg Ballentine—they looked at it and both said it seemed correct to them.

Al Warren of the Harvard Law School has published a paper in the last year in the National Tax Journal in which he's looked at my analysis and said it's basically sound.

So the answer is, yes, indeed, I have done this for a fee. But it does represent my best judgment of what the issues are and my best effort to clarify those issues.

Chairman RANGEL. Professor, nobody else has apologized for getting a fee that's testified today. [Laughter.]

Mr. GRAETZ. I didn't mean that as an apology.

Chairman RANGEL. It was just when you were giving out your grades, I didn't know whether Yale was doing it or Metropolitan was doing it.

Mr. GRAETZ. No, no, Metropolitan has been paying me for my work.

Chairman RANGEL. Mr. McGrath.

Mr. MCGRATH. I thank Professor Graetz for coming today and giving us the benefits of his insights on this topic.

As I said when the previous panel finished their testimony, I think that today was a good start; an interim report; a preliminary hearing on a very complex subject which I'm sure, within the next year or so, we're going to have to address.

I'm looking forward to further examination of the numbers and the background behind those numbers. I'm also looking forward to working with you, Mr. Chairman, and the other members of the committee, in coming up with a solution to this particular problem.

Chairman RANGEL. Mrs. Kennelly.

Mrs. **Kennelly**. Thank you, Mr. Chairman.

I just want to tell you that I balance with public assistance and this committee.

Chairman **Rangel**. Mr. Dorgan.

Mr. **Dorgan**. Mr. Chairman, let me observe for the committee that I've been at a Customs hearing on another subcommittee most of the morning.

But I was able to review some of the testimony today prior to the hearing. I just want to ask one question. I have looked at the testimony presented prior to the Professor's testimony. And some are suggesting that 809 is simply in need of modification, and you are suggesting that we move to an entirely different tract and attempt to define economic income.

Can economic income be defined within some modification of 809, in your judgment?

Mr. **Graetz**. Well, what my analysis says is that in the natural course of things, if you tax premiums as they come in as a source of capital, to mutual companies, and allow a full deduction for policyholder dividends, and do not tax capital as it comes into stock companies, but also do not allow any deduction for stockholder dividends, that the tax, in present value terms at the company level will be the same over time. The taxes will be paid at different points in time, but the tax will be the same over time.

I have not tried to ask the question, "What kind of modification to section 809 would be appropriate if you wanted at the company level to reflect a difference at the policyholder level?"

I know that Gerry Brannon has done some work recently on that question, and he suggested that there may be about a 2-percent differential or something like that that would be required to address the policyholder level question.

I want to emphasize to you that I think there are two kinds of problems in section 809. One of them is trying to get the number set appropriately, for whatever genuine purposes are in the committee's mind, and if the committee wants to impose a company tax as a proxy, like the tax on shareholders, I agree with Mr. Pike, we have done that before elsewhere in the code, and it may well be a way to revise section 809.

In my judgment, that kind of justification would not justify the level of uncertainty and necessary interaction among companies that section 809 now has.

To me, the most bizarre thing about section 809 is that on the mutual company side—and it has not happened on the stock company side—every mutual company's taxes are not dependent on its own economic performance, whatever that performance is.

Their tax depends on what happens with other mutual companies, and depends on what happens with stock companies.

I do not think, in an effort to really answer your question, I do not think that within that kind of context, section 809 can be made to work in a way that impose, for each company, the right amount of tax.

I think it is inherent in the decision to base this tax on segments that whenever you say, whatever rule you came up with that said, we want to collect this much tax from one segment, and this much tax from another, then you are necessarily saying that no company's taxes will depend on its own economic performance. Their taxes will depend on the performance of the other segment, and other companies within its own segment.

And I think that is what has to be abandoned. And that is one of the fundamental tenets of section 809.

Mr. **Dorgan**. Mr. Graetz, thank you very much. This Yale, it's a 4-year college?

Mr. **Graetz**. You couldn't tell it from our football team on Saturday.

Chairman **Rangel**. Mr. Downey is not a member of the subcommittee, but he has an interest in the subject. Do you have any questions?

Mr. **Downey**. I do, Mr. Chairman. I have two questions.

First of all, Professor Graetz, you were here during Professor Pike's testimony, and maybe you can help me with a couple of things.

As far as I can tell, and I have had the opportunity to read your analysis, I have not heard of anyone that disputes it actively. So I suspect that you might be in a better position to inform the subcommittee if there is anyone to your knowledge who has looked at your analysis and found it wanting in some respect?

Mr. **Graetz**. I think that no one has looked at the analysis as it is set forth in the paper that I gave at the Yale Conference and that was subsequently published and said that it is not correct, in any way.

I think that the questions have turned around policy responses, or empirical questions about the importance of various pieces of this puzzle, one of which is the transition issue, which I mentioned an another is the policyholder level issue.

And there have been, I know, stock company papers submitted by Mr. Harman to the Treasury Department at least, on the transition issue, and also mutual company papers submitted by Mr. Nolan on the transition issues.

And they reach different conclusions. I am sure it's fair to say the stock companies, while they may not disagree with the basic analysis, would say it is not a good reason for going forward as a policy matter.

Mr. **Downey**. Can I ask you with respect to whether grandpa's capital contribution to mutuals was taxed in any way? This appears to be a somewhat esoteric question, but it is one that Professor Pike raised.

And I just thought I would like to explore it if you could with me and maybe help me sort it out. You mentioned that there has been some further analysis.

Can you explain its relevance for us as we look at this issue in the future, and how we might draw some conclusions as to what we do in the future?

Winston Churchill said in 1940 that if he picked a quarrel between the past and the present, we were likely to lose the future. This could be amended to say that if we pick this sort of quarrel, we're likely not to understand either the present or the future as we begin this process of dealing with this.

But I would appreciate it if you would deal with that subject, since you alluded to it briefly in your testimony.

Mr. **Graetz**. Mr. Downey, I take it the grandpa's tax question is this transitional question of what happened prior to 1984.

I was confused, I have to admit, in the colloquy as to who grandpa was, whether grandpa was the founder of a mutual company, or whether grandpa was a policyholder from prior years.

If grandpa was the founder of a mutual company, if organizational capital came into a mutual company, then that organizational capital was not taxed, as I understand it, under prior law.

If grandpa was a policyholder, there is a great dispute, I gather, about whether the capital was or was not taxed as an empirical matter. The mutual company paper suggests that it was taxed, and in fact, was overtaxed.

The stock company paper suggests that it was never taxed.

So there is a factual question at the outset that should be resolved, I think, by looking at it in some comprehensive way, a question about whether it was or was not taxed.

Then there is a policy question, an analytical question, about what one does, assuming it was or was not taxed. I take it the mutual company paper says, if it was taxed, that's the end of it.

If the capital was not taxed, it really does raise a question of what does that mean for the future. In particular, the basic question is, if the 1959 act or the 1928 act, was not a good law, what do we do, going forward, in order to redress problems under prior law.

There is a real dispute about that in the literature, and what happened as a result of that is in dispute.

It may well be that if mutual companies were undertaxed relative to stock companies, that that advantage was capitalized in the value of share prices of stockholder—of stock companies.

And if those share prices went up, because at that time stock companies had an advantage—or if the prices went down because at that time mutual companies had an advantage, then what would be doing today is giving current shareholders a windfall benefit by going back to address that advantage.

I think there are difficult policy issues. In general the Congress moves forward without trying to go back and correct problems under prior law. But this may be an instance where you want to think specifically about that problem.

Chairman **Rangel**. Thank you, Professor.

And the committee stands adjourned.

[Whereupon, at 12:58 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of
Coleman Bloomfield
Chairman and President
The Minnesota Mutual Life Insurance Company

Mr. Chairman and members of the subcommittee:

My name is Coleman Bloomfield. I'm Chairman of the Board and President of The Minnesota Mutual Life Insurance Company located in St. Paul, Minnesota ("Minnesota Mutual"). I'm taking this opportunity to present the following written testimony on behalf of Minnesota Mutual to be incorporated into the official record of the House Ways and Means Select Revenue Measures Subcommmittee's hearing held on September 27, 1988 on life insurance company taxation.

The Subcommittee is to be commended for holding this hearing to gather information about how the life insurance tax provisions of the 1984 Deficit Reduction Act are working. Those provisions were discussed rather broadly at the hearing by witnesses from the U.S. Department of Treasury and the General Accounting Office. Those witnesses very capably addressed how the provisions are affecting the insurance industry as a whole. My testimony will describe how the provisions affect *one* mutual life insurance company. I hope the facts I will share with you will help you in your deliberations next year relative to changes to the Act.

Minnesota Mutual is a medium-sized mutual life insurance company. Headquartered in St. Paul, Minnesota, it has conscientiously served its insurance clients since the Company's inception over 108 years ago. At year end 1987 the Minnesota Mutual was the 42nd largest life insurance company in the United States with just over $4 billion in assets. We employ 1,500 people at our Home Office in St. Paul and we have 2,000 agents representing us across this nation. Approximately 1 million people currently look to the Minnesota Mutual for protection of their own personal financial security.

I will set forth two fundamental considerations:

1. Minnesota Mutual is not one of the industry giants. While the Minnesota Mutual Life is a Company of substance and has achieved continuous success throughout its 108 years, we actively compete with 41 companies that are larger, of which essentially 19 are larger mutual companies and 22 are larger stock companies.

2. Minnesota Mutual is autonomous. Our future performance is not linked to the performance of any other company nor to any group of companies. There is no necessary relationship between our future financial performance and that of other stock or mutual companies, whether they be larger or smaller than we are.

I believe there are two fundamental changes needed:

1. The basis of taxation for our Company should be such that our Company's tax, year by year, will rely solely on its own economic income.

2. The basis of taxation for our Company should parallel that of other corporations by eliminating the differential tax imposed through Section 809.

The intent of the Deficit Reduction Act of 1984 was to tax life insurance companies on their own economic income, parallel to other corporations. It has apparently worked for stock life insurance companies. It has not worked for mutual life insurance companies — particularly Minnesota Mutual.

WRITTEN STATEMENT OF
John S. Nolan, Esq.
Miller and Chevalier, Chartered

THE PREPAYMENT ANALYSIS REVISITED:
Graetz Conclusions Are Correct

On November 3, 1987, the Stock Company Information Group ("SIG"), an organization comprised of the largest stock life insurance companies in the United States, submitted a paper to the Treasury entitled "An Interim Analysis of Section 809: Reactions to the 'Graetz' Theory". This "interim reappraisal" of Section 809 of the Internal Revenue Code, the 1984 tax provision imposing a special additional tax on mutuals, was submitted in the light of the analysis of Section 809 by Professor Michael J. Graetz in "Life Insurance Company Taxation: An Overview of the Mutual vs. Stock Differential" (hereinafter "Graetz Paper"). The Graetz paper and other related papers were published in Life Insurance Company Taxation; The Mutual vs. Stock Differential (M. Graetz ed., 1986, Rosenfeld Emmanuel, Inc.) (hereinafter "Yale Conference Volume"), after having been presented at a conference held at the Yale Law School in March, 1986.

The purpose of these comments is to revisit the Graetz prepayment analysis and to consider and address each of the points raised in the SIG paper.

I. The Stock-Mutual Ownership Differential Issue

A. The Enactment of Section 809.

The 1984 Act, for the first time, undertook correctly to tax stock life insurance companies on their full economic income. The 1984 Act properly abandoned earlier efforts to tax life insurance company underwriting income and investment income differently. The Act determined reserves for tax purposes by applying more stringent interest assumptions. The Act repealed special life insurance company deductions which bore no relationship to actual current costs and expenses. In general, the Act sought to tax stock life insurance companies with a single phase tax on "full economic income" (i.e., taxable gain from operations.)

Similarly, the Act sought to tax mutual life insurance companies on their economic income (determined on the same basis as for stock companies) supplemented, however, by an ownership differential amount determined under Section 809. Section 809, which applies only to mutual life insurance companies, imputes and adds to the taxable income of each mutual a "differential earnings amount". This amount is obtained by multiplying a specified industry based rate of return (the "differential earnings rate") by each mutual's "average equity base".

The addition to taxable income of mutual life insurance companies required by section 809 was intended by Congress to redress a perceived competitive advantage in the market for life insurance products. Congress believed that such an advantage would otherwise accrue to mutual companies as a result of their ability to pay a deductible "equity-like" return to mutual policyholders. While undistributed profits (retained earnings) are taxed on the same basis to both stock and mutual companies under an economic income tax base, contributed capital and returns on that capital are treated differently (although as the prepayment analysis has demonstrated, equivalently).

Stock life insurance companies are organized in the ordinary corporate manner with ownership by shareholders. Shareholders of stock life insurance companies receive typical shareholder returns on the capital they contribute to the enterprise.

Classical corporate tax rules apply to stock life insurance companies. Shareholder contributions of capital are not considered taxable income to the stock company. On the other hand, stock companies get no deduction for shareholder dividends.

In contrast, mutual life insurance companies have no shareholders. Mutual companies get their capital from policyholders through redundant portions of policyholder premiums. This source of capital is taxed as premium income. Absent any special adjustment, all amounts transferred by the policyholders to the company would be included in company income, and all policyholder dividends would be deducted by the company.

B. The Prepayment Analysis

The Graetz paper demonstrates that under a reasonable set of assumptions -- that stock and mutual companies are subject to the same constant tax rate and earn similar rates of return -- a tax on economic income that includes in income of mutual companies capital received from policyholders in the form of redundant premiums and allows a full deduction of policyholder dividends will burden mutual companies in a manner identical in present value to the tax burden of stock companies. The present value effect is exactly the same as excluding shareholder contributions of capital from income and not allowing any deductions for shareholder dividends.

The prepayment analysis thus demonstrates that a tax on economic income of both mutual and stock companies, without any limitation on the deduction of policyholder dividends, will result in equivalent tax burdens on the two segments of the industry over time. This means that taxing economic income of mutual companies without any special disallowance of policyholder dividend deductions creates parity between mutual and stock companies with respect to equity contributions in the form of redundant premiums. Accordingly, section 809 is not justified. The mutuals pay tax on their capital when it is received, and they should be allowed a full deduction for policyholder dividends to provide equivalent tax treatment to stock companies, which do not pay tax on their capital when received but pay tax on the returns on that capital because shareholder dividends are not deductible.

Since the gain from operations tax base produces an equivalent tax base for mutual and stock life insurance companies no arbitrary adjustments to the mutual company tax base are needed. Further, since economic income produces an equivalent tax base for mutual and stock life insurance companies, it is not necessary to resort to "segment balance" measures or other outside indicia in order to properly tax mutual life insurance companies.

C. The SIG Interim Analysis

The SIG paper is an incomplete and biased discussion that clouds rather than clarifies the issue. Overall, it appears designed to deflect the Treasury and Congress from engaging in the comprehensive reexamination of the merits of Section 809 that the prepayment analysis compels.

The SIG paper is nevertheless important, not for what it argues but for what it concedes. It does not dispute the validity of the Graetz prepayment analysis. Throughout, the SIG paper essentially concedes that there may well be equivalence in stock and mutual taxation without the need for a mutual differential, so long as mutual capital received as redundant premiums is initially taxed.

The entire thrust of the SIG paper is not that the prepayment analysis is wrong but that mutual companies may hold "untaxed" equity capital today which was received without tax many years ago. The existence of this alleged untaxed equity capital is said to preclude application of the prepayment analysis, which assumes that all mutual equity capital is initially taxed. Put simply, the SIG defense of the section 809 mutual differential comes down to the argument that it is needed to reverse prior tax laws, needed solely for "transitional" reasons.

Three separate issues are raised related to this allegedly untaxed equity capital. One issue involves pre-1984 redundant premiums. A second issue relates to organizational capital, capital alleged to have been received tax-free in connection with the organization of a new mutual company. The third issue concerns to post-1983 redundant premiums, equity elements of premiums received by mutual companies since 1984. Each of these issues will be separately addressed.

Although the SIG paper suggests that mutuals have untaxed equity capital, no facts are offered to support this contention. This paper will demonstrate the converse that all mutual equity capital has in fact been taxed. Even if the SIG paper were factually correct, however, a transition policy question would have to be addressed: does sound tax policy mandate that mutuals be required to pay an extra tax under current law to make up for taxes that were not imposed in prior years?

II. The Threshold Issue of Transition Policy

The question concerning the appropriate legislative policy with respect to any pre-1984 redundant premiums, or organizational capital which may have been received tax-free by mutual companies, is the same question as that raised with respect to any change in the tax law.

There is no current competitive advantage in the market for life insurance products accruing to mutual companies even if they enjoyed a tax advantage under the law in effect during periods prior to 1984. Any such tax advantage that might have existed under the 1959 Life Insurance Company Tax Act (the "1959 Act") or earlier laws (advantages that did not in fact exist) would have been promptly capitalized in the value of equity shares of stock companies. The redressing of such an advantage now would tend simply to produce unwarranted windfall gains to existing shareholders of stock companies. There is little or no policy justification today for attempting to recapture the benefits, if any, that might have accrued to mutual companies in raising capital through pre-1984 redundant premiums.

As a general policy matter, in enacting changes in tax law Congress has tended to adopt effective date provisions designed to produce proper results post-enactment, without endeavoring to correct in the future for tax distortions that might have occurred under prior laws.

Many legislative examples could be adduced to demonstrate the long-standing Congressional practice of looking only to the future, rather than to the past, when changes in the tax law are enacted. Three such examples seem worthy of mention here. First, in 1950, when Congress enacted the tax on unrelated business income of tax exempt organizations, and again in 1969, when the scope of that tax was significantly broadened, the tax was imposed only with respect to years subsequent to enactment. This forward-looking response was considered appropriate even though Congress regarded the prior law exemption from tax of such income to have been in error and to have produced disadvantages to competitors of the tax exempt entities. No adjustment was even considered for the accumulation of tax-free capital that had accrued prior to 1950 (or 1969).

Similarly, in 1986, when Congress decided to tax for the first time the income of the Blue Shield and Blue Cross insurance companies, the tax was enacted on a prospective-only basis, and no adjustment was made because such companies had heretofore accumulated capital while enjoying tax-exempt status.

An even more compelling example of Congress ignoring the effects of prior law occurred in 1984 when the life insurance company tax law was revised. Congress rejected the notion that it should recapture the substantial tax benefits that stock companies received from being able to defer indefinitely taxes on one-half of their underwriting gains. Stock life insurance companies had been permitted to retain earnings on a tax-free basis; while the deferral provision was repealed prospectively, no attempt was made to recapture the benefits. The Phase III accounts were frozen, with stock companies forever enjoying the benefits of the earnings on the equity which accumulated tax-free under the 1959 Act.

Both sound policy reasons and precedent argue against any adjustment in the post-1984 taxation of mutual life insurance companies in response to the fact that at various times prior to the 1984 Act these companies might have acquired capital free from income tax. Indeed, as will be demonstrated subsequently, mutual life insurance companies were overtaxed in comparison to stock companies under prior laws. It is a long stretch indeed to attempt to defend the disallowance of post-1984 policyholder dividends under section 809 on the grounds that mutual companies received capital tax-free prior to 1959. But, even assuming arguendo that they were advantaged under pre-1959 laws, mutual companies were over-taxed under the 1959 Act in amounts sufficient to compensate for any pre-1959 capital that had been received tax-free.

III. Pre-1984 Redundant Premiums (Capital Received As Premiums Prior to 1984)

The SIG Interim Analysis asserts that the entire equity of mutual life insurance companies as of January 1, 1984, is composed of "untaxed capital." This assertion turns on a critical analytical mistake, coupled with some rhetorical sleight of hand. The SIG paper (in footnote 30) uses the term "untaxed capital" to mean "mutual premium receipts that did not bear tax at the margin."

Essentially two issues are involved with respect to the pre-1984 capital of mutual companies: (1) whether any portion of the capital received prior to 1984 can be said to be capital received free of tax, and thus similar to capital received by a stock company free of tax; and (2) whether as of January 1, 1984, mutual companies retained any advantage as a result of capital received tax-free in prior years.

As the prepayment analysis clearly demonstrates, a disallowance of deductions for the return on capital -- either in the form of shareholder or policyholder dividends -- is equivalent in present value terms to taxing the capital when received and allowing a full deduction for dividends. The SIG paper agrees that beginning with the Corporate Excise Tax of 1909, a portion of policyholder dividends of mutual companies has always been denied deduction; this is equivalent to taxing receipt of at least some portion of mutual capital received in the form of post-1909 to pre-1984 redundant premiums. This fact on its face directly contradicts the SIG assertion that "mutual life insurers underwriting income previously has not been taxed." (SIG Interim Analysis at 20.)

Historically, the tax laws applicable to life insurance companies have undergone a number of changes. Up to 1921, life insurance companies were taxed on an economic income base which included their investment income and premium income (and which limited to some extent policyholder dividend deductions). Capital received as premiums by mutual companies was clearly taxed "at the margin" during those years. Between 1921 and 1957, life insurance companies were taxed solely on the basis of their investment income. This investment income tax base afforded no deduction for policyholder dividends. Thus, rather than accumulating equity on a tax favored basis from 1921 to 1957, mutual companies generally paid a heavier effective tax than they would have paid had they been taxed on their full economic income i.e., investment income plus underwriting income (taxing premiums and deducting policyholder dividends).

The 1959 Act (effective 1958-1983) sought to return life insurance companies to a total economic income base. Both stocks and mutuals were taxed on the basis of their "taxable gain from operations", which included both investment and premium income. Stock companies benefited, however, from certain non-economic special deductions and from a provision deferring tax on substantial underwriting income. Mutuals, on the other hand, were subject to a special limitation on their deductions for policyholder dividends. These dividend deductions could not reduce taxable gain from operations below a separately computed floor, referred to as "taxable investment income" or "Phase I". This produced a taxable gain from operations for mutual companies substantially in excess of their economic income, i.e., the tax base that would obtain from including redundant premiums in taxable income but also permitting a full deduction for policyholder dividends.

For example, if a mutual company had $120 of tentative taxable gain from operations before policyholder dividends, paid policyholder dividends of $35, but had "taxable investment income" of $100, only $20 in policyholder dividends could be deducted. Policyholder dividends could not reduce taxable gain from operations below "taxable investment income". The balance of policyholder dividend deductions would be disallowed, and the company would have a final taxable gain from operation of $100, $15 in excess of its real gain from operations.

It is in this context that SIG asserts that premium income was not taxed "at the margin" under the 1959 Act. By this SIG means only that an additional dollar of premiums would not have increased the ultimate mutual company tax base because of the "taxable investment income floor" on policyholder dividends deductions. This absence of tax at the margin however, resulted only because the tax base for mutual companies exceeded their gain from operations after policyholder dividends, which gain was determined by including the full amount of premiums received in gross income.

Since the prepayment analysis demonstrates that policyholder dividends must be deducted in determining economic income, mutuals paid tax over the years 1959-1984 on more than their full economic income. The only reason that mutual company premiums were not taxed at the margin under the 1959 Act is that mutuals were subject to a disallowance of dividend deductions which resulted in a substantially higher tax burden. The weakness of the SIG argument is demonstrated by the fact that had mutuals paid less tax (on economic income with a full dividend deduction), SIG would have to agree that the premiums were taxed "at the margin".

Therefore, contrary to the assertion of the SIG paper, the 1959 Act did not allow mutuals to accumulate capital tax-free. The 1959 Act taxed mutual capital twice: first by requiring the inclusion of redundant premiums in income when received, and again by disallowing deductions for policyholder dividends when paid. It may well be that the 1959 Act was too generous to both stocks and mutuals with respect to the scope of reserve and other deductions that it provided. But those benefits and tax rules applied to both stocks and mutuals. They have nothing to do with the mutual differential.

The conclusion that mutuals paid tax on the full amount of premiums received is inescapable. As underscored by William B. Harman, Jr., in his article, "The Pattern of Life Insurance Company Taxation Under the 1959 Act," 15 Tulane Tax Institute, 686, 718, the 1959 Act "taxes a life insurance company at ordinary corporate rates on its income from all sources." He added that while some experts referred to the tax on mutual companies as a tax on investment income --

> some persons (including the author) contend the typical mutual company is on a total income tax base, with a limitation on its policyholders' dividends, or gain from operations. While this limitation is couched in terms of an investment income floor, the floor is an arbitrary one with many assumptions.

Under the 1959 Act, mutual life insurance companies were generally taxed on at least their gain from operations. Thus, capital received as redundant premiums in the years 1958-1983 was subject to tax.

While taxing capital received and accumulated by mutuals during the period 1958-1983, the 1959 Act by its disallowance of dividends also taxed the return on and return of capital which accumulated prior to 1958.

As shown above, there is no evidence that any prior tax law favored mutual life insurance companies in comparison to stock companies. The formulae used for the tax years prior to 1957 tended to overtax mutual life insurance companies since investment income rather than economic income was the tax base. Further, amounts in excess of any capital that may have been received tax-free were paid out as non-deductible dividends or as non-deductible returns of organizational capital during those periods. Capital that might have been received "untaxed" was returned to policyholders.

Even if we were to assume arguendo, however, that all of the equity held by mutual companies as of January 1, 1958, was the result of tax-free equity received prior to that point, that entire prior law tax benefit was demonstrably offset by operation of the 1959 Act between the years 1958-1983. Thus, the 1959 Act operated to disallow deductions equal to more than the sum of the equity which had accumulated prior to 1958 plus the earnings on that equity subsequent to 1958.

Page 10 is a numerical analysis that quantifies the relationship of the taxable income actually reported by mutual operations tax base (including investment income). H. Rep. 34, 86th Cong. 1st Sess., H.R. 4245 (1959 2 C.B. at 740). companies during the period 1959-1983 to the taxable income that would have been reported during that period if mutual companies were taxed on an economic income base increased to reflect a non-deductible return of all of the equity as of January 1, 1958, and the earnings thereon. For purposes of this analysis, it was assumed that the equity was paid out over 20 years. The analysis demonstrates that the tax base for mutual companies during the 1959 Act years exceeded the level required for a return of all equity on hand on January 1, 1958. Disallowed mutual company policyholder dividends during the years of the 1959 Act gradually (and ultimately fully) offset pre-1959 Act mutual equity as well as the earnings on that declining equity. For purposes of this analysis, mutual company equity as of

January 1, 1958, is estimated to have been $7.5 billion. The economic income and tax data are based on compilations made by the American Council on Life Insurance.

The estimation procedure compares economic income under the 1959 Act (gain from operations with premiums included in income and policyholder dividends deducted) with taxable income for mutual companies. By adjusting economic income to effect a return of pre-1958 equity (and earnings thereon) tax-free, a "hypothetical" taxable income for the mutual segment is determined. By comparing the hypothetical taxable income with the actual taxable income reported, the analysis demonstrates that mutual companies were taxed on more than the economic income during the period from 1958 to 1983 and that this higher tax base effectively offset any benefit attributable to pre-1958 equity.

Professor Sims in his Commentary on the Graetz paper concluded that the "transition problem" associated with the change to a tax based on economic income could be dealt with if non-deductible distributions over time equal "effective date equity plus earnings on effective date equity until such time as the total actually is distributed". The Sims test is exactly the test that has been applied here, and the results show that this test is more than met. The analysis in Appendix A demonstrates that by fully taxing mutual company premiums, while denying deduction for substantial amounts of policyholder dividends, the 1959 Act gradually reached and taxed the entire pre-1959 Act mutual equity and the full earnings on that equity. Indeed, the analysis shows that the 1959 Act operated to disallow even a greater portion of policyholder dividends than the level proposed by Professor Sims.

Thus, the extensive disallowance of dividend deductions under the 1959 Act more than offset any benefit mutual companies could have received under laws existing prior to 1958. In consequence, mutual company equity as of January 1, 1984, was considerably lower than it would have been had mutual companies been taxed prior to the 1984 Act on a gain from operations base which included contributed equity (including organizational equity) in taxable income.

While mutual companies were being overtaxed under the 1959 Act in relation to their economic income, stock companies were being undertaxed. A major portion of stock company retained income escaped taxation under the 1959 Act as the result of the so-called Phase III deferral and special deductions for non-participating and accident and health insurance available as a practical matter only to stocks. This enabled stock company equity to grow during the 1959 Act period in a tax-preferred manner, so that as of January 1, 1984, stock company accumulated untaxed retained earnings exceeded $5.5 billion.

Unquestionably, it is the stock companies rather than the mutual companies that were tax-favored under prior law. As of the effective date of the 1984 Act, stock company equity far exceeded the level it would have reached if a tax on economic income had been consistently applied. On the other hand, mutual company equity fell far short of the level it would have reached if a tax on economic income had been consistently applied. If there is a transition problem with respect to a pre-1984 law tax benefit, it is quite different from the one suggested in the SIG paper.

IV. Organizational Equity

A. Pre-1959 Act Organizational Equity (Organizational Equity Received by Mutual Companies in Years Prior to Application of the 1959 Act)

The SIG Interim Analysis deals separately with organizational equity. It concedes that no organizational or founders' capital was received by mutual life insurance companies during the twenty-five year period between enactment of the 1959 and 1984 life insurance tax laws. Delving back further, it argues that mutual life insurance companies must have received start-up or organizational capital tax-free at some time in their histories prior to the 1959 Act, and that a tax benefit from this capital therefore continues today.

For the reasons explained earlier, no adjustment is needed with respect to organizational equity received prior to 1958. Most, if not all, of the organizational equity would likely have been returned by the companies in a non-deductible manner in the pre-1959 Act years. If, however, some of that equity existed on January 1, 1958, the 1959 Act as has been previously shown offset any benefit that might have been obtained. It did so by disallowing policyholder dividend deductions equal to more than that equity and the earnings thereon.

B. Post-1983 Organizational Equity (Organizational Equity Received by Mutual Companies in 1984 Act Years)

The SIG paper argues that there must be a limitation on mutual companies' ability to deduct returns paid to future suppliers of organizational capital to mutual companies. The paper argues that since the receipt of such capital (unlike redundant premiums) will not be included in mutual taxable income, future newly-organized mutual companies may enjoy a potential tax advantage over stock companies, as well as over existing mutual companies.

The Graetz prepayment analysis suggests a simple legislative solution to this hypothetical problem. Organizational or founders' capital supplied to mutual life insurance companies could simply be treated as additional premium income in the year received. A simple adjustment of this nature would then place contributions of founders' capital on the same basis as post-1983 redundant premiums. A tax on economic income that included in income post-1983 organizational equity and allowed a full deduction for policyholder dividends, as well as for periodic payments with respect to founders' capital, would achieve the proper income tax result. This would equate the present value of the tax burdens of mutual and stock companies. It would impose the appropriate tax burden on each life insurance company, regardless of whether such company was organized as a stock or mutual company. It would eliminate any need for the unreasonably complex section 809-type mechanism simply to deal with a problem which is more theoretical than real.

V. Post-1983 Redundant Premiums (Equity Elements of Premiums Received Under the 1984 Act)

In a final effort to justify an ownership differential, the SIG Interim Analysis argues that even if the Graetz prepayment analysis is correct, it is "irrelevant" with respect to post-1983 redundant premiums. Thus, the SIG paper argues that the section 809 mutual tax differential "automatically corrects" for the prepayment of tax on capital received as premiums under the 1984 Act.

In building this strange argument, the SIG paper accepts the Graetz analysis that stock and mutual taxation is equivalent under an economic income tax base without a mutual tax differential, but still insists that the differential mechanism be retained rather than repealed. In support, it points to the fact that although redundant premiums of mutuals are taxed under the 1984 law, the differential mechanism itself includes these premiums in determining the mutual earnings rate for differential purposes. Hence, the differential mechanism affords the mutuals "credit" for these premiums and is "self correcting". If by this the SIG paper is saying that repeal of section 809 is unnecessary because the current differential mechanism neutralizes itself or self-destructs, it is engaging in circular logic. Sound tax policy is not served by perpetuating a tax differential which has no justification for its existence other than that it corrects itself. If this is all that the SIG paper is saying, the differential surely should be repealed.

On the other hand, this SIG argument may really contemplate only a small self-correction in the totality of the differential. It may only be saying that mutuals receive some credit against the mutual differential for equity now taxed as redundant premiums, but that much of the differential remains after this credit and is justified as a tax on pre-1984 Act untaxed mutual equity. There would be no merit to this argument. As the prior sections of this paper demonstrate, there is no justification for an ownership differential or other dividend disallowance with respect to capital accumulated under prior law, since all that capital has been previously taxed.

VI. Conclusion

The SIG Interim Analysis does not discredit the policy relevance of the prepayment analysis offered by Professor Graetz in the Yale Conference. In fact, it concedes the basic analysis, offering only transitional arguments which are not grounded in sound policy nor supported by the facts. Unfortunately, the SIG Interim Analysis represents little more than the most recent effort by the stock company segment of the life insurance industry to impose and maintain an excessive tax burden on the mutual segment of that industry, in the apparent hope either that the stock segment's own tax burden might thereby be reduced or that, by achieving an excessive tax on mutual companies, stock share values might increase as the market capitalizes the tax disparity.

This paper has discussed in detail each of the sources of capital of mutual companies that is addressed in the SIG Interim analysis. It has shown that with respect to post-enactment capital obtained by mutual companies in the form of redundant premiums from policyholders, a tax on economic income with a full deduction of policyholder dividends will, over time, produce, equal tax burdens on the income of stock and mutual companies alike.

Those seeking retention of section 809 are reduced to arguments that such an adjustment is needed as a correction for the pre-1984 Act taxation of capital raised by mutual companies prior to 1984. This kind of reason for adopting or retaining section 809 is far different from that offered in 1984 when the provision was first enacted. The SIG Interim Analysis does not offer any convincing rationale for retaining section 809 on such grounds.

Beyond this, as shown, the SIG Interim Analysis is factually and analytically inaccurate with respect to capital raised in the form of redundant premiums during the period 1959-1984. Any pre-1984 Act mutual company equity capital has already been taxed. Even had it not been taxed, there are policy considerations that suggest that an effort in current legislation to undue tax advantages or disadvantages of the past would be inappropriate.

ESTIMATE of MUTUAL TAX OVER/(UNDER) PAYMENTS
FOR TAX YEARS 1958 - 1983 INCLUSIVE
(amounts represented in thousands)

YEAR	(1) Total Equity Attributable Pre '58 Equity (1)+(7)-(8)	(2) Estimated Total Equity	(3) Total Equity Attributable Post '57 Prems (2)-(1)	(4) Return of Eqty. Attributable Pre '58 Equity	(5) Pre-Tax Current Earnings Rate (Mutual)	(6) Tax Rate	(7) A/T Earnings Attributable Pre '58 Equity (1)*(5)*(1-(6))	(8) P/H Dividends Repr. Return of Pre '58 Equity (4)+(7)	(9) G.F.O. After P/H Dividends	(10) Hypothetical Taxable Income (9)+(8)	(11) Hypothetical Tax (10)*(6)	(12) Taxable Inc. Reported to I.R.S.	(13) Estimate of Tax Paid (12)*(6)	(14) Tax Overpaid / (Underpaid) (13)-(11)	(15) Cumulative Tax Overpaid / (Underpaid)
1958	7,500,000	7,500,000	0	250,000	3.72%	52.00%	133,920	383,920	412,000	795,920	413,878	543,000	282,360	(131,518)	(131,518)
1959	7,250,000	7,957,916	707,916	260,000	3.85%	52.00%	133,980	393,980	452,000	845,980	439,910	583,000	303,160	(136,750)	(273,331)
1960	6,990,000	8,443,791	1,453,791	271,000	3.96%	52.00%	132,866	403,866	485,000	888,866	462,210	664,000	345,280	(116,930)	(401,086)
1961	6,719,000	8,959,331	2,240,331	282,000	4.08%	52.00%	131,585	413,585	555,000	968,585	503,664	713,000	370,760	(132,904)	(550,354)
1962	6,437,000	9,506,348	3,069,348	293,000	4.18%	52.00%	129,152	422,152	537,000	959,152	498,759	803,000	417,560	(81,199)	(654,558)
1963	6,144,000	10,086,763	3,942,763	305,000	4.28%	52.00%	126,222	431,222	577,000	1,008,222	524,276	894,000	464,880	(59,396)	(741,969)
1964	5,839,000	10,702,615	4,863,615	318,000	4.36%	50.00%	127,290	445,290	664,000	1,109,290	554,645	985,000	492,500	(62,145)	(836,464)
1965	5,521,000	11,356,069	5,835,069	331,000	4.42%	48.00%	126,895	457,895	645,000	1,102,895	529,389	1,080,000	518,400	(10,989)	(884,425)
1966	5,190,000	12,049,419	6,859,419	344,000	4.58%	48.00%	123,605	467,605	709,000	1,176,605	564,770	1,188,000	570,240	5,470	(919,462)
1967	4,846,000	12,785,103	7,939,103	358,000	4.68%	48.00%	117,932	475,932	725,000	1,200,932	576,447	1,364,000	654,720	78,273	(884,220)
1968	4,488,000	13,565,704	9,077,704	373,000	4.85%	52.80%	102,739	475,739	863,000	1,338,739	706,854	1,530,000	807,840	100,986	(826,119)
1969	4,115,000	14,393,965	10,278,965	388,000	5.00%	49.20%	104,521	492,521	872,000	1,364,521	671,344	1,622,000	798,024	126,680	(740,745)
1970	3,727,000	15,272,796	11,545,796	404,000	5.20%	49.20%	98,452	502,452	935,000	1,437,452	707,227	1,735,000	853,620	146,393	(632,871)
1971	3,323,000	16,205,284	12,882,284	420,000	5.40%	48.00%	93,310	513,310	941,000	1,454,310	698,069	1,841,000	883,680	185,611	(481,434)
1972	2,903,000	17,194,706	14,291,706	437,000	5.60%	48.00%	84,535	521,535	1,220,000	1,741,535	835,937	2,170,000	1,041,600	205,663	(302,732)
1973	2,466,000	-18,244,538	15,778,538	455,000	5.80%	48.00%	74,375	529,375	1,442,000	1,971,375	946,260	2,442,000	1,172,160	225,900	(94,390)
1974	2,011,000	19,358,468	17,347,468	473,000	5.89%	48.00%	61,593	534,593	1,116,000	1,650,593	792,285	2,550,000	1,224,000	431,715	331,766
1975	1,538,000	20,540,409	19,002,409	493,000	5.99%	48.00%	47,906	540,906	945,000	1,485,906	713,235	2,642,000	1,268,160	554,925	906,564
1976	1,045,000	21,794,516	20,749,516	513,000	6.16%	48.00%	33,473	546,473	920,000	1,466,473	703,907	2,861,000	1,373,280	669,373	1,631,781
1977	532,000	23,125,189	22,593,189	532,000	6.39%	48.00%	17,677	549,677	1,018,000	1,567,677	752,485	3,167,000	1,520,160	767,675	2,503,727
1978	0	24,537,110	24,537,110	0	6.72%	48.00%	0	0	1,518,000	1,518,000	728,640	3,728,000	1,789,440	1,060,800	3,732,777
1979	0	26,035,236	26,035,236	0	6.98%	46.00%	0	0	1,160,000	1,160,000	533,600	4,141,000	1,904,860	1,371,260	5,364,585
1980	0	27,624,830	27,624,830	0	6.53%	46.00%	0	0	1,737,000	1,737,000	799,020	2,521,000	1,159,660	360,640	6,075,532
1981	0	29,311,479	29,311,479	0	6.64%	46.00%	0	0	1,355,000	1,355,000	623,300	1,268,000	583,280	(40,020)	6,438,928
1982	0	31,101,106	31,101,106	0	8.92%	46.00%	0	0	531,000	531,000	244,260	1,986,000	913,560	669,300	7,682,580
1983	0	33,000,000	33,000,000	0	7.94%	46.00%	0	0	(331,000)	(331,000)	(152,260)	951,000	437,460	589,720	8,882,297